

Pension fund investment and capital markets

Mombasa, 31 October 2008

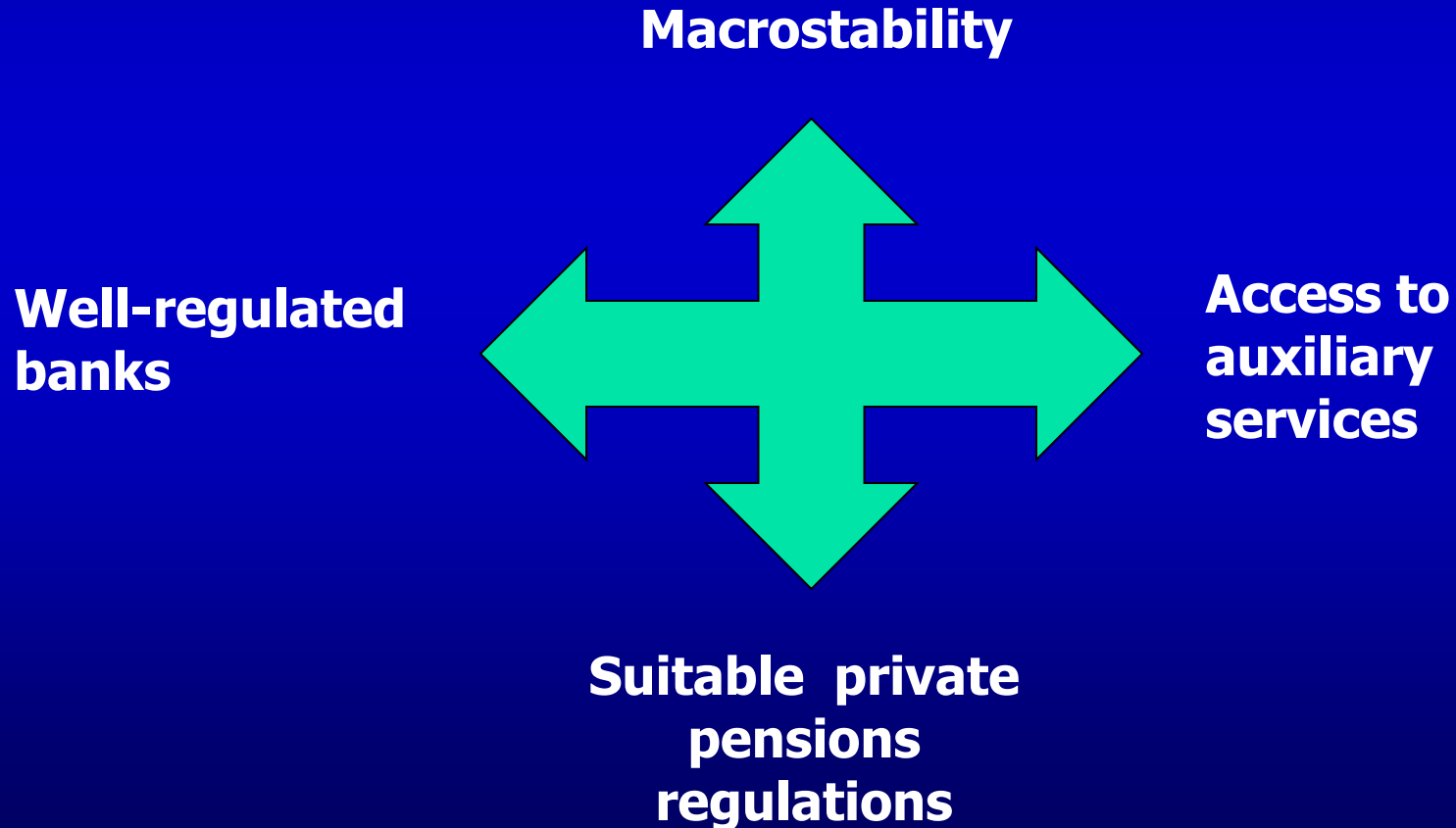
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Issues for discussion

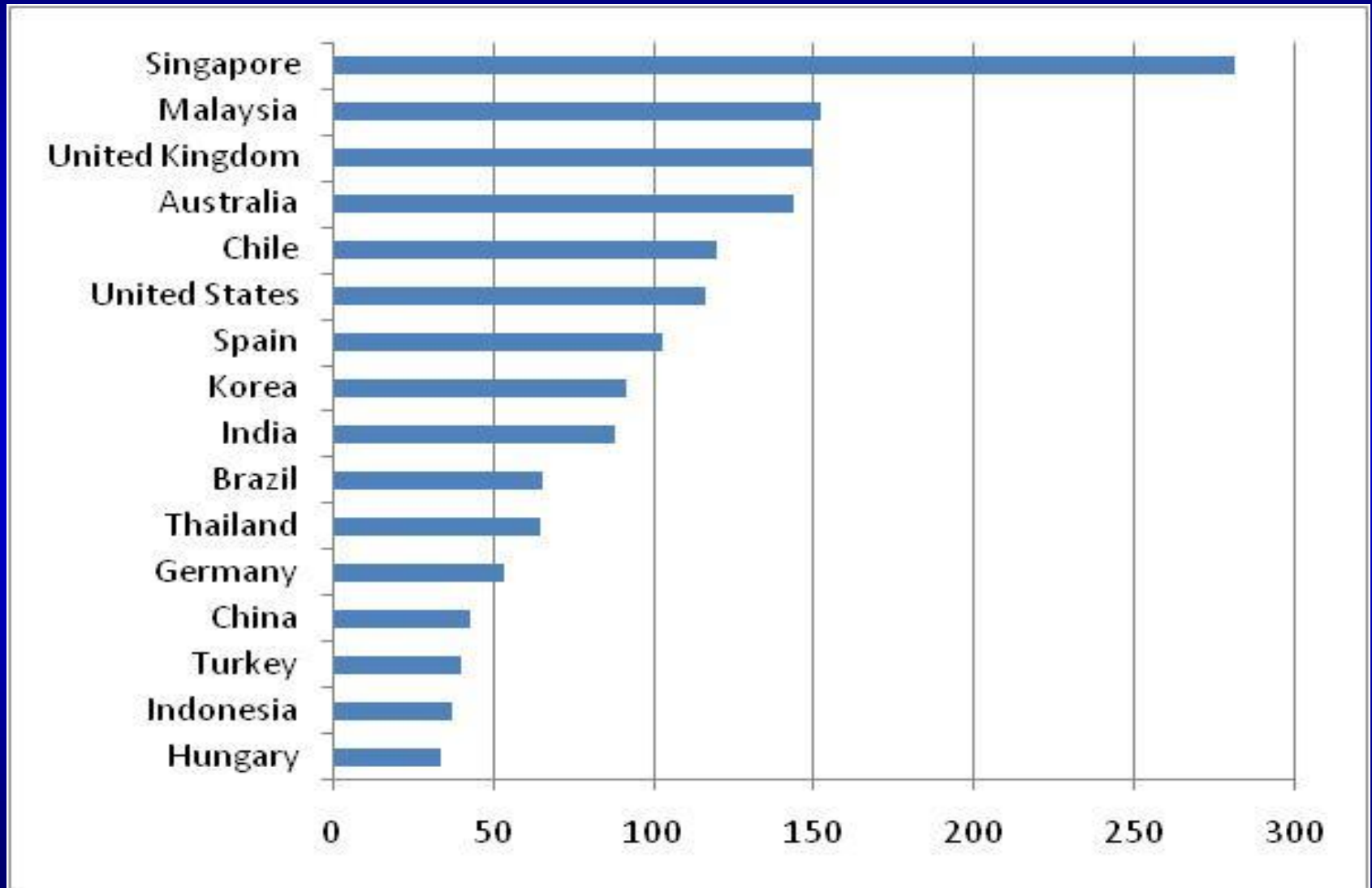
- Preconditions for a successful interaction between pension funds and capital markets
- Designing investment regulations to enhance returns and improve financing for productive activities
- Challenges and opportunities of alternative investments: case study of infrastructure

Preconditions and key determinants of capital market impact of pension funds



Richer countries tend to have larger stock markets

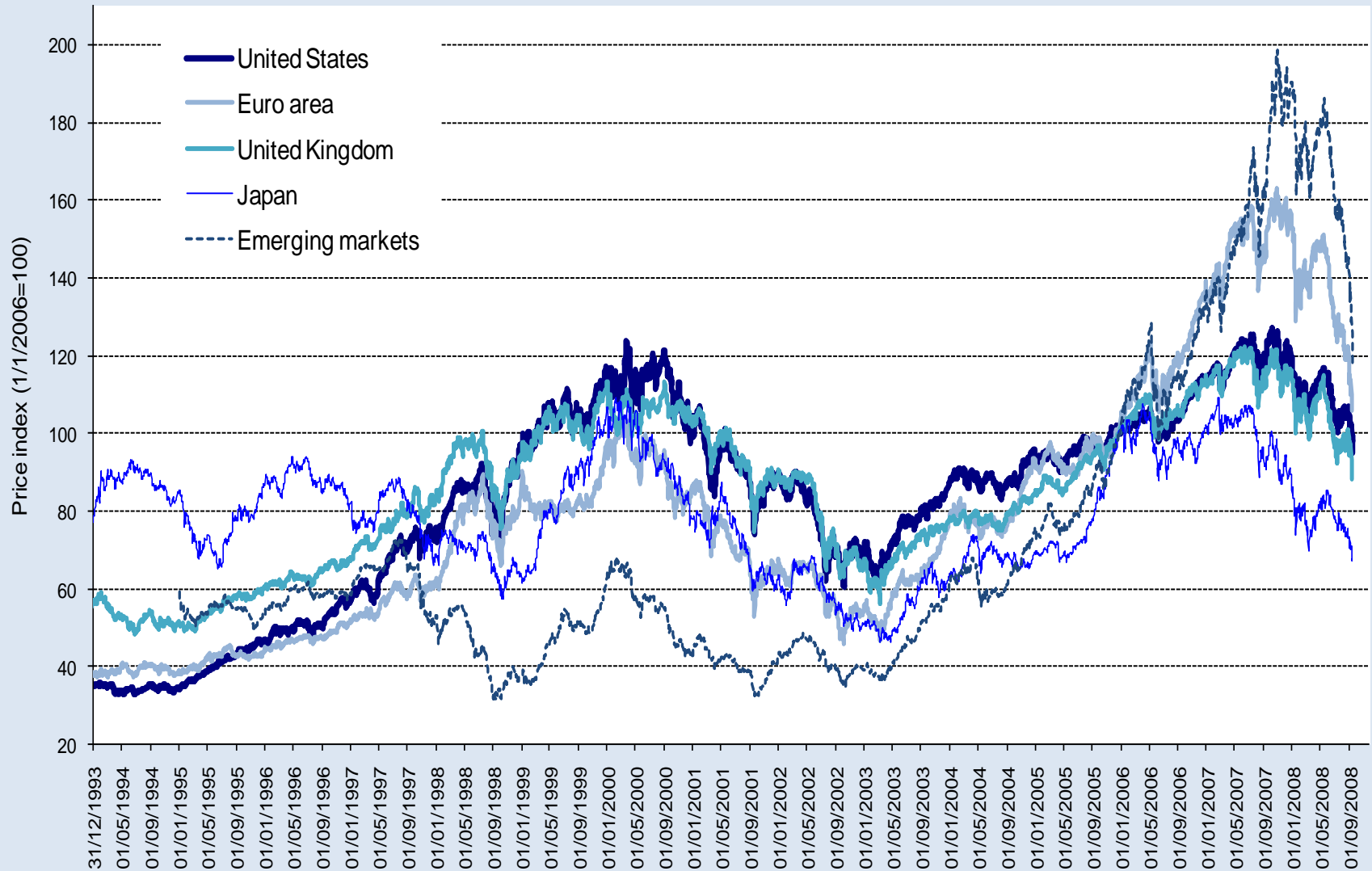
Market capitalisation as per cent of GDP



Source: World Federation of Stock Exchanges (2008)

...and tend to be less volatile than emerging markets

Major stock market performance



Source: Datastream

How much capital market development is needed?

- Concerns over excess leveraging and product complexity in unregulated markets
- Economic link financial sector development - growth (both positive and negative) mainly via bank credit
- Role of stock markets in corporate governance restrained by pension funds' passiveness

Investment regulation trends in OECD countries

- Gradual relaxation of quantitative investment limits
- Implementation of prudent person standard
- Quantitative risk measures (e.g. VaR, stress tests) starting to be used in both DB and DC systems

Recent relaxation of quantitative limits

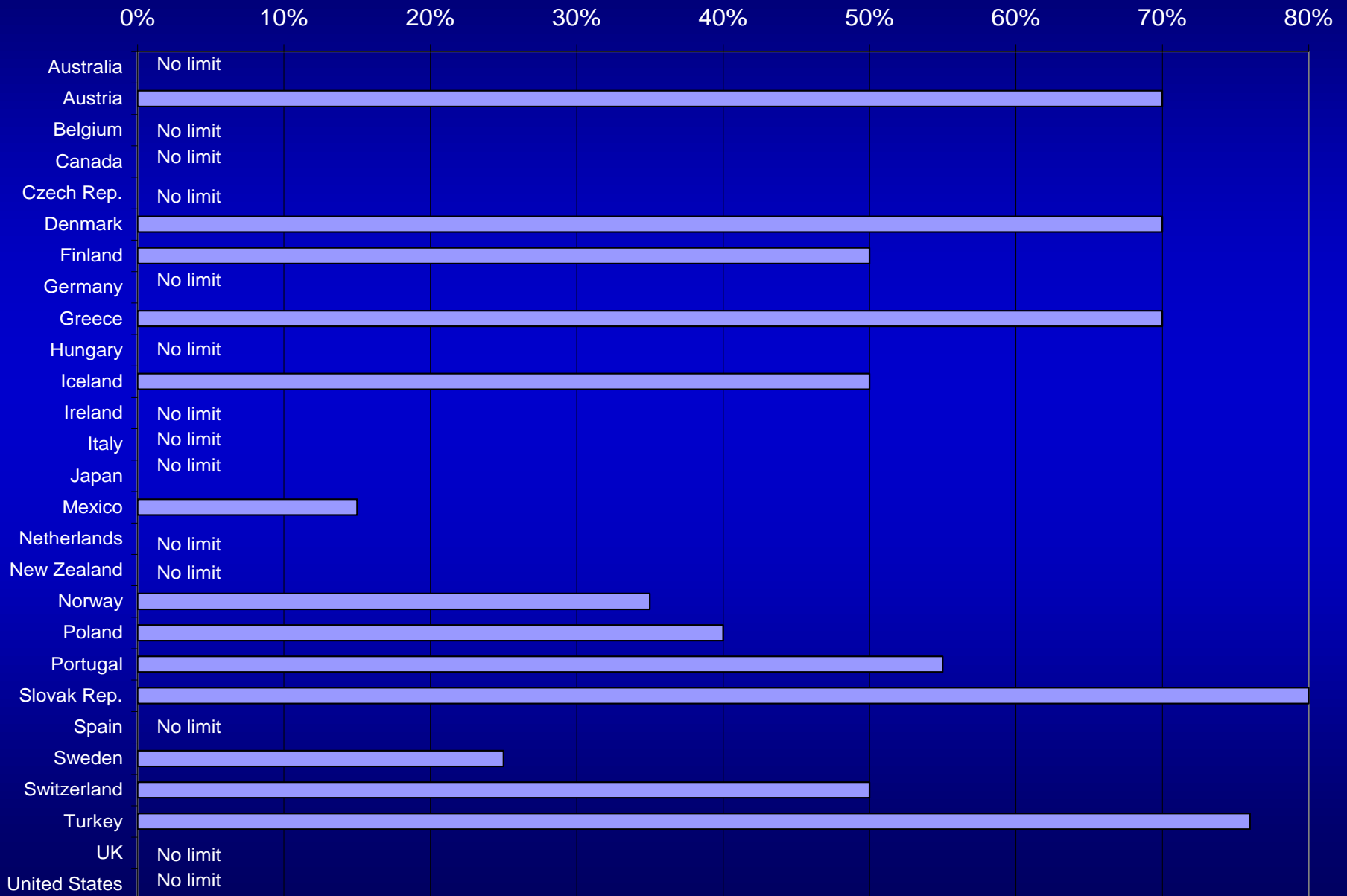
Shares:

- Belgium: 65% - no limit (2002)
- Czech Rep.: 25% - no limit (2004)
- Denmark: 50% - 70% (2001)
- Mexico: 0% - 15% (2005)
- Portugal: 50% - 55% (2002)
- Spain: 10% - 30% for unlisted (2003)

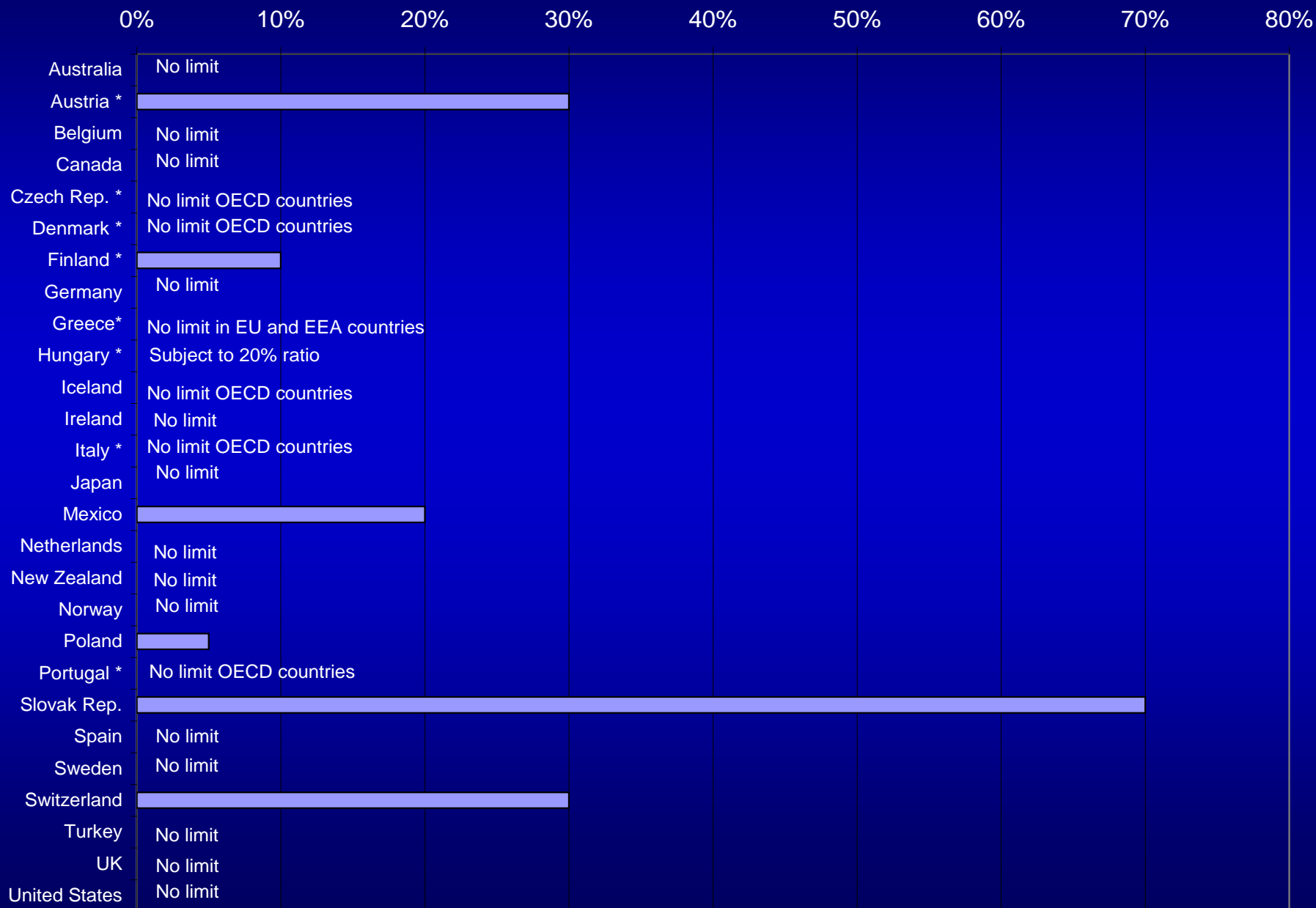
Foreign investment:

- Japan: 30% - no limit (1999)
- Canada: 30% - no limit (2005)
- Denmark: 5% - 10% for non-OECD (2005)
- Mexico: 0% - 20% (2005)
- Germany: no limit for *Pensionsfonds* (2002)
- Korea: 20% - 30% (2003)

Limits on shares



Limits on foreign investment



"Prudent" quantitative limits

- Limits on % of portfolio invested in individual securities or issuers
- Limits on ownership concentration (if direct control not desirable)
- Limits on % of portfolio invested in non-transparent/illiquid instruments

But can be left to self-regulation via the "prudent person rule"

OECD Guidelines on Pension Fund Investment Management

- Requires prudent person; allows some quantitative limits (e.g. self-investment), discourages investment floors (e.g. government bonds)
- Requires “expert knowledge”, “duty of loyalty” and “due diligence”
- Written investment policy and risk control process
- Market value preferable

Pension fund investment in infrastructure: pros

- Long horizon
- Market power, often regulated
- Stable, predictable, often inflation-indexed cashflows
- In some countries, tax-effective
- Low correlation with other sectors
- Relatively low default rates
- Socially responsible

Pension fund investment in infrastructure: cons

- Is it really a separate asset class?
- Leverage exposure
- Complexity and illiquidity of unlisted infrastructure
- Hard to value assets
- Lack of long-term performance data
- Political, regulatory and environmental risks
- Fees

www.oecd.org/daf/pensions