

KRISTÍANA BALDURSDÓTTIR<sup>1</sup>

## Pension funds' assets and return on investment

*The Icelandic pension fund system has witnessed large growth in recent years and the pension funds are now larger than the deposit money banks. Pension funds have made major changes in their investment strategies and are focusing increasingly on foreign markets as well as domestic equities. In 1999 the pension funds' return on assets was much better than in recent years. This article discusses the development of Icelandic pension funds over the period 1980-2000.*

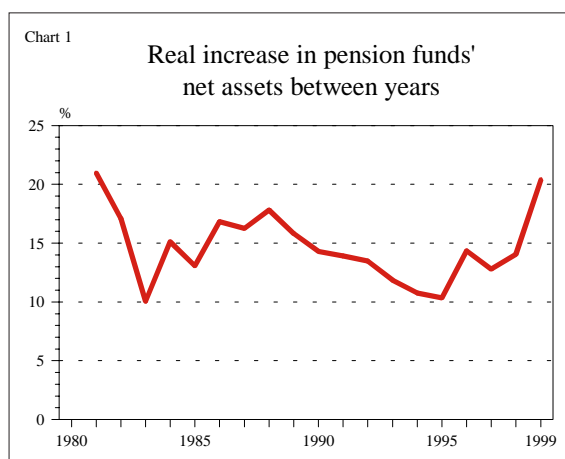
Active pension funds in Iceland totalled 62 at the end of 1999. Of these, 13 no longer received premiums, 15 enjoyed employers' guarantees and 34 were fully operational general pension funds. The number of pension funds has been decreasing steadily in recent years, from 88 at the end of 1991. The main reason for this reduction is that funds have been merging in order to cut operating costs and achieve greater economies of scale. This development may be expected to continue in the next few years. Under the Act on Compulsory Insurance of Pension Rights and the Activities of Pension Funds (no. 129/1997), pension funds are obliged to apply for an operating permit which is issued by the Minister of Finance after consideration by the financial supervisory authority. Virtually all the pension funds have now been granted operating permits. One condition for issuing them is that at least 800 members pay monthly premiums to the pension fund, unless the fund ensures that the risk on its commitments is spread in another way consistent with an actuarial investigation (Art. 21). Undoubtedly this condition has led to even further fund mergers after the act went into effect.

Before the Act became law, pension funds were either defined-benefits funds or defined-contributions funds, but the latter may no longer operate.

However, most pension funds operate a defined contributions department and are thereby authorized to accept contributions to supplementary retirement saving schemes.

### *Net assets of pension funds*

The net assets of pension funds are the capital available to them in order to meet their commitments towards members, i.e. total assets less liabilities. Net assets of pension funds at the end of 1999 are estimated at 517.9 b.kr. and have been growing rapidly in recent years. The increase in real terms, i.e. the increase after the respective end-of-year position has been adjusted to the price level in January 2000 using



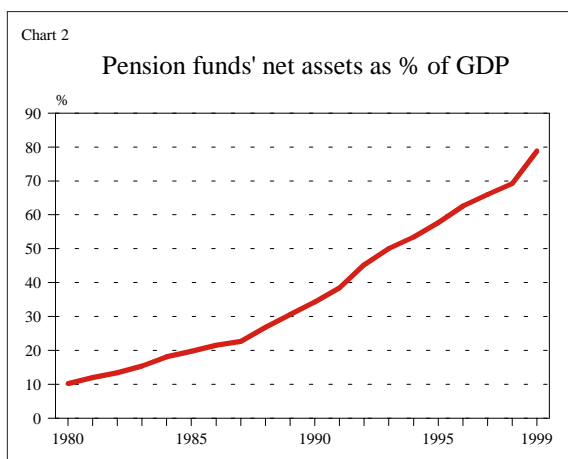
1. The author is Division Chief at the statistics department of the Central Bank of Iceland.

the CPI, amounted to more than 20% in 1999, the highest figure since 1981. The real increase has fluctuated somewhat over the past 20 years and was lowest in 1983, 1994 and 1995, at 10 or 11%.

Net assets of pension funds at the end of April 2000 are estimated at 551.2 b.kr., having increased by 33.3 b.kr. from the beginning of the year, or 6.4%. This estimate is based on monthly reports from the largest pension funds, which between them account for 90% of net assets of all pension funds, meaning that this must be considered a very reliable indicator.

With net assets of 517.9 b.kr. at the end of 1999, the pension funds represented a very large component of the credit system, as shown by the fact that lending and marketable securities of the banking system totalled 482.4 b.kr. and assets of investment credit funds (including the State Housing Fund) 432.5 b.kr.

The following chart shows net assets of pension funds at year-end as a proportion of GDP for the year. At the end of 1980 this ratio was just over 10%, but has been steadily increasing since, and at an accelerating rate after 1990. That year it stood at 34%, while at the end of 1999 it is estimated at almost 79%.



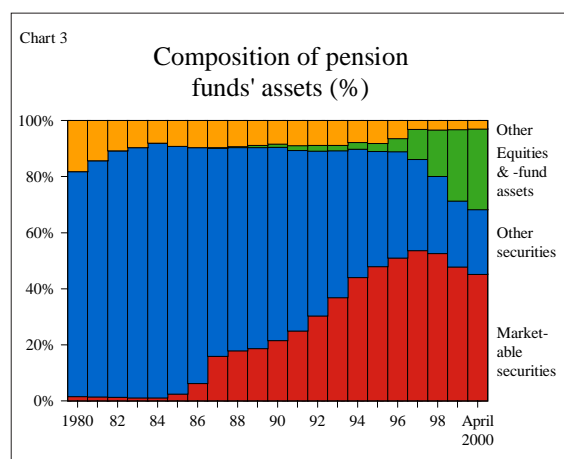
#### *Pension funds' asset composition*

The composition of the pension funds' assets has changed significantly over the past 20 years as they have kept pace with the major transformations which have taken place in the capital market environment since 1980. Their role is to produce the optimum return on members' assets, and they design their

investment strategies in accordance with the legal limits governing investments in specific classes of security and investment risk. Over the period 1980-1986, 80-90% of their assets were tied up in "other bonds", namely direct lending and non-marketable bonds. Since then, the share of such securities in the pension funds' total assets has been declining rapidly and by the end of 1999 was only 24%.

In the second half of the 1980s pension funds began investing in marketable securities, issues of which began at this time and increased rapidly afterwards. The share of marketable bonds in total pension fund assets peaked in 1997 at almost 54%, but has been declining in the past few years and at the end of 1999 was just over 47%.

At the same time as pension funds began to pare down their assets of marketable bonds and their assets in other bonds were steadily declining, they turned to investments in equities and equities funds. Pension funds really began serious investment in this area in 1997 and their assets in equities and equity funds, both domestic and foreign, amounted to 37.8 b.kr. at the end of that year. By the end of 1999, this asset category had reached almost 132 b.kr., or more than a quarter of their total assets. Of these 132 b.kr., 83 b.kr. are of foreign origin. Presumably, the reason for this change in the funds investment strategies has been that they have managed to achieve a good return on their foreign stock, which produced a return of 39% in 1999, compared to 15% in the previous year. Pension funds held almost 46 b.kr. in domestic equities at the end of 1999, but they have



only acquired units in domestic equity funds on a small scale.

An estimate of the pension funds' position at the end of April shows that the trend during 1999 has been continuing, with a contraction in holdings of marketable and other bonds, but a large increase in equities and equity fund units, amounting to almost 27 b.kr. over the first four months of 2000.

#### *Pension funds' foreign securities holdings*

The Pension Funds Act (no. 129/1997) contains provisions about their investment strategies and sets limits for investment in specific types of securities, including the limitation of foreign currency risk (Art. 36). An amendment to the Act, passed by Parliament on May 8 this year, extends the limit on permissible foreign-denominated investments from 40% of a pension fund's net assets to 50%. Despite the massive increase in their foreign security stock in recent years, pension funds still have considerable scope regarding such investments. Few of them have more than 30% of net assets denominated in foreign currencies, many more are close to the 20% mark. Not all pension funds have entered this field yet; in particular it is the larger ones which have done so.

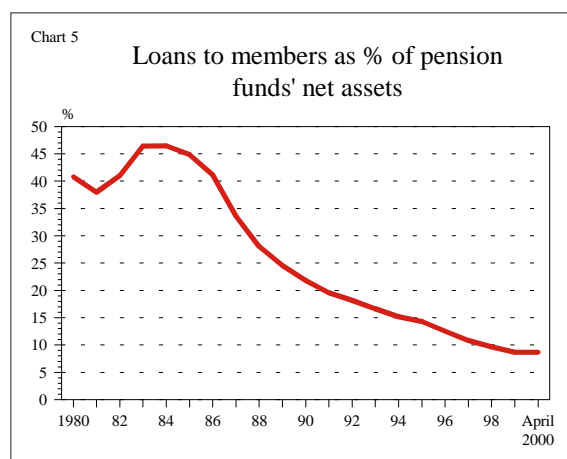
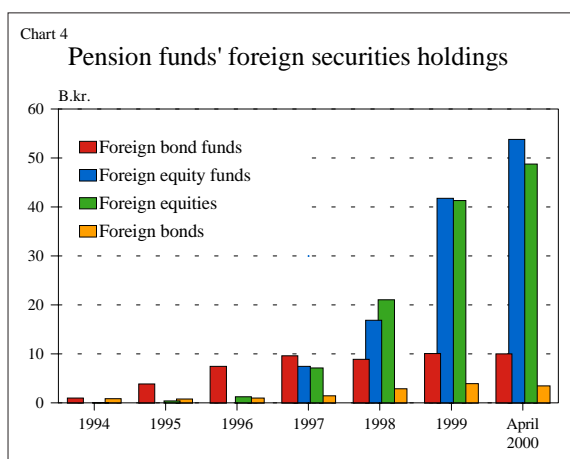
Pension funds began to invest overseas in 1994, initially on a very small scale. At the end of that year their foreign equities stock amounted to only 1.8 b.kr. A fairly cautious approach was taken for the next two years, but since 1997 funds have been increasingly focusing on investments overseas. At the end of 1999, their foreign security stock stood at

97 b.kr., and during the first four months of 2000 they added almost 19 b.kr. to these portfolios. Between 85 and 90% of their foreign assets are in the form of equities and equity funds. The term "equity funds" here refers to those funds which invest solely in equities, while mixed funds investing in both bonds and equities are classified as bond funds. Foreign bonds have not proved popular among Icelandic pension funds and assets in foreign bond funds have increased little since 1996, as the accompanying chart shows.

#### *Loans to members*

In the 1980s, loans to members were a major aspect of pension fund operations. In 1980 these accounted for 40% of the funds' net assets and in 1983-1984 this ratio exceeded 46%. Since then, the share of loans to members has been steadily decreasing and now, in April 2000, is equivalent to only 8.7% of net assets, or just under 48 b.kr. One reason is that the pension funds' rules impose a ceiling on lending to members, and this limit has lagged behind net asset growth. Furthermore, not all members take advantage of their funds' credit facilities, although more of them tend to do so under special conditions, for example during expansionary trends in the housing market.

The increase in loans to members has been fairly steady over the past few years, until 1999 when it climbed sharply as a result of expansion in the housing market. The twelve-month increase until the end of April 2000 was more than 7 b.kr., and the increase during the first four months of this year almost 3 b.kr.



### *Pension funds' disposable capital*

The disposable capital of pension funds is the inflow of capital to them less the outflow on account of pension payments and operating costs. The inflow comprises on the one hand collected premiums, and on the other hand, proceeds from the sale of securities and repayments on loans granted and purchased securities, irrespective of whether this revenue represents interest, amortization or price indexation.

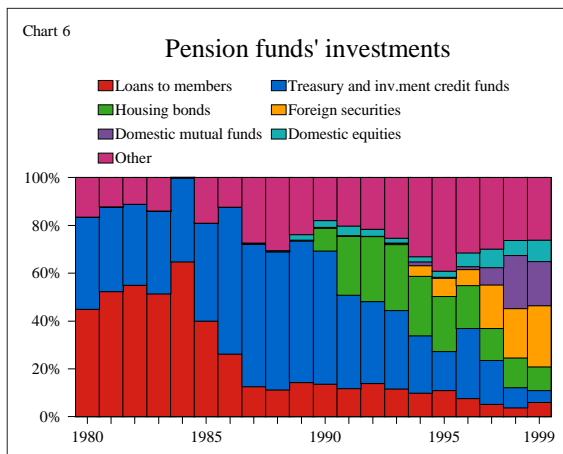
The funds' disposable capital in 1998 amounted to almost 130 b.kr., a major increase from the 81 b.kr. of the previous year. The share of disposable capital derived from premiums has been steadily decreasing since 1982, when it was equivalent to 86% of the total. Disposable capital for funds as a whole amounted to 163 b.kr. in 1999, of which just over one quarter derived from premiums.

As a proportion of GDP, disposable capital remained fairly stable during the 1980s in the range 3.6-6.3%, but since 1990 it has been growing rapidly. In 1999 it is estimated at 25% of GDP. The main explanation for this enormous increase is that funds are playing a more active part in the securities market, and typically sell securities which do not produce an adequate yield and buy better-performing ones. In 1997 the pension funds sold securities to the amount 19 b.kr., which was equivalent to 23% of their disposable capital for that year. A year later, when total disposable capital was almost 130 b.kr., some 54% derived from proceeds from the sale of securities, or almost 70 b.kr. Disposable capital less proceeds from the sale of securities dropped in real terms by 2.6 b.kr. between 1997 and 1998. Pension funds are estimated to have sold securities to the amount 87 b.kr. in 1999, a similar proportion of their disposable capital to the previous year's figure.

In the period after 1980 around half of disposable capital was allocated to loans to members, and the bulk of the remainder to securities issued either by the treasury or the investment credit funds. Towards the end of the 1980s loans to members contracted sharply relative to disposable capital, at the same time as the weighting of bank bonds and corporate bonds increased. As outlined above, pension funds then began investing in foreign securities in 1994, when they allocated 4.5% of their disposable capital to this item, but 5 years later this ratio had risen to 25%.

During the first years after the introduction of the housing bond system, in 1991-1995, pension funds allocated almost one-quarter of their disposable capital to purchases of housing bonds, but such investments have been declining since and in 1999 had fallen to 10% of disposable capital.

Pension funds' purchases of domestic and foreign equities have increased sharply in the past few years and accounted for 20% of disposable capital allocations in 1999. The same year, purchases of securities fund units amounted to 23% of disposable capital. This illustrates the major shift that has taken place in the pension funds' investments in recent years, whereby the focus is now on foreign securities, equities and securities fund units, instead of the earlier loans to members and treasury-guaranteed securities.



### *Operating costs*

Operating costs measured as a proportion of premiums remained steady in the period after 1980, in the range 3.4-4.2% right up until 1996. In 1997 this figure fell to 2.5% and last year it appears to have dipped below 2%. Measured in terms of net assets, pension funds' operating costs amounted to 0.8% in 1980 and have since gone down to around 0.2% for the past 3 years.

### *Net real return on investment*

Net real return on investment is the return on the funds' assets relative to the CPI after expenses (operating costs + other expenses - other revenues) have been deducted from investment revenues. Over the period 1993-1998 the net real return on investments

by the pension funds as a whole was in the range 6.6-7.9%. ROI peaked in 1997, then fell the following year to 7.4%. The outlook is for a significant improvement in 1999, when many funds achieved a

double-digit figure for ROI. The following table presents examples of net real return on investment for selected major pension funds over the past 5 years.

Table 1 Net ROI of pension funds

<i>% p.a.</i>	1995	1996	1997	1998	1999
Lífeyrissjóður verslunarmanna (Retail and clerical workers).....	7.1	7.4	10.2	7.6	11.8
Lífeyrissjóðurinn Framsýn (Labour).....	.	7.7	8.0	8.4	14.7
Lífeyrissjóður starfsmanna ríkisins A-deild (State employees Section A).....	.	.	.	6.7	15.2
Lífeyrissjóður starfsmanna ríkisins B-deild (State employees Section B).....	5.9	4.4	5.5	5.8	7.6
Lífeyrissjóður starfsmanna ríkisins Séreignardeild (State employees defined contributions scheme).....	.	.	.	.	17.4
Lífeyrissjóður sjómanna (Seamen).....	6.7	7.4	6.9	8.0	12.4
Sameinaði Lífeyrissjóðurinn (General).....	7.7	8.0	8.2	7.2	17.8
Söfnunarsjóður lífeyrisréttinda (Cumulative fund).....	6.8	7.2	8.6	6.5	10.3
Lífeyrissjóður bankamanna (Bank employees).....	5.8	5.4	5.5	6.3	7.5
Samvinnulífeyrissjóðurinn (Cooperative fund).....	6.2	7.4	13.0	7.2	12.5
Lífeyrissjóður Vestfirðinga (West Fjords).....	7.4	9.0	6.0	8.0	14.2
Lífeyrissjóður lækna (Doctors).....	8.0	11.8	8.0	8.0	16.3
Lífeyrissjóður Verkfræðingafélags Íslands (Engineers).....	4.1	9.2	6.4	11.0	21.6
Lífeyrissjóður Vesturlands (West Iceland).....	7.7	11.0	6.0	6.7	15.9
Lífeyrissjóður hjúkrunarkvænna (Nurses).....	6.4	5.6	5.9	6.5	9.1

Source: Pension funds' annual accounts.