

## Building Trust

Our journalist asked USAID Capital Markets Project Senior Pension Lawyer Natalya Goryuk and Senior Regulatory advisor David Bardsley to give their view\* on how Non-State Pension Funds could be better armed for the crisis.

### **Q: What type of anti-crisis measures should be taken in order to ensure that NPFs can pay out pensions?**

A:

Healthy funds have little to worry about. Fund participants and administrators should keep in mind that they are working from a long-term perspective. Therefore, today's crisis – and the same goes for tomorrow's bull market – should average out over the working life of a participant.

Ukraine being a market economy, it has to manage the downside of a market with defensive investments. If pension funds follow reasonable and transparent investment practices, short-term losses will be self-correcting as Ukraine (along with other industrial countries) recovers from the recession. Pension funds, like other investors, must resist the temptation to sell assets at low values if they expect those assets to recover value during an economic recovery. However, if a particular asset has little or false value because its value was previously manipulated, then it should be sold and a better asset purchased at current low values.

The crisis also has positive aspects: it weeds out the weaker funds. There are more than 90 active NPFs in Ukraine at the moment with a total of 552.1 million UAH (about 52 million Euros) of assets under management for 2008. In Poland, only about 27 funds manage pillar III pension investments reaching a total of 587 million Euros in assets. This shows that the consolidation process that has started in Ukraine is both inevitable and necessary. And it will not affect the contributors: their accounts will be transferred to a surviving, and therefore stronger fund.

Loss in value is temporary, providing that assets are managed with the needed expertise, and valued in a transparent and fair manner. That's why the present crisis is a good time to correct certain mistakes, and to take measures that will ensure that pension funds are managed according to these basic principles. The funds that are currently failing are the funds that hold little or no assets or are not following these principles.

First, the funds can take measures to make sure they have a sound investment policy. That means that they need to have competent and knowledgeable people in their investment council or if they don't have such an in-house council, according to law, they should hire knowledgeable external advisors. These investment professionals can then advise on the right investment strategy: how to diversify, how to build sound portfolios. Ukraine's pension funds need more of these experts versed in capital markets. The

expertise in asset management companies also needs to be improved since their members will be making the final investment decisions. Asset managers need to have the necessary expertise, and have to be non-interested parties. The law provides for such qualifications but we have to make sure that the SSMSC fulfills these supervisory and enforcement obligations.

Second, it could be a good time to introduce new instruments into the market, for instance, inflation-linked bonds that would be attractive because relatively safe to investors. Third, the funds and the regulators need to recognize and correct a number of significant failings in the system that come to light when the market is weak. A major weakness in the current system is that NPFs do not appear trustworthy.

One reason is the murky accounting practices used today. The method used by NPFs to credit investment returns allows leveraging, meaning that the values recorded in the individual accounts do not always reflect the actual value of the assets that support the accounts. As a result, participants may see account values that do not reflect the real situation of the NPF. The NPF may be a lot worse off than the account valuation makes it seem.

So for participants to gain trust in the NPFs, it is absolutely essential to introduce and implement accounting methods that do not leave any place for manipulation.

Funds will also appear more reliable and honest when the way assets are valued becomes more transparent. Current proposed regulations would require pension funds to value the assets of the fund at the current market value. This would not only meet international standards, but would greatly reduce the possibility of manipulation of the value of fund assets.

Yet confidence in the market would grow even further, if funds and other market participants take the step to reveal their ownership – not only will this increase trust in the pension funds, it will also help solve the domestic markets liquidity problems by attracting investment, both domestic and international.

If the regulator and the NPFs make these changes, then one of the results of the crisis will be to make the Ukrainian pension market stronger, and establishing the trust of workers as the holders of their retirement savings. //

*\* The views and opinions of author expressed herein do not necessarily state or reflect those of the U.S. Government or the USAID*