

Recession Provides Opportunity to Strengthen Pillar III

Gary Hendricks, Senior Pension Advisor/Head of Pension Reform Department, USAID/Capital Markets Project (CMP)*

Like all recessions, the one currently underway in Ukraine has revealed weaknesses in Pillar III pensions and the financial systems that support them. As pointed out in my previous column, most of these were already known. The recession simply underscores their importance.

The extent of decline in equity reflects the weakness of stock markets as an institution in Ukraine and how poorly the interests of institutional investors including Non-State Pension Funds (NPFs) are being served. The PFTS index fell by 80%, more than any other stock market index in the world, although negative experience in Russia is rapidly outpacing Ukraine. The dramatic fall in equity values is partially the result of a lack of transparency, liquidity, and confidence because some Ukraine companies prefer to conduct their transactions off-exchange and off shore. It is unlikely that equity values would have fallen nearly as much if stock exchanges functioned as open markets where everyone could participate fairly. Part of the dramatic fall of the PFTS may also be an indication of the amount by which equities were overvalued before the recession due to lack of transparency in a highly illiquid market.

Moreover, to the extent that asset managers avoid investing new contributions in equities, the pension funds are not helping to stabilize equity markets, as in other countries, and investment behavior is perverse. The failure of pension funds to take advantage of low equity values through their asset managers indicates a widespread belief that equity markets in Ukraine are not open honest markets that can be relied upon to provide solid increases in value during the economic recovery.

The recession should also be used to correct weaknesses in NPFs. The current methods of crediting investment returns permit NPFs to avoid deducting losses in market value from individual accumulation accounts. This permits leveraging, which means the values recorded on the individual accounts may be less than or greater than the actual market value of the assets that support the accounts. This approach to accounting is the same as the one that precipitated worldwide crisis in financial markets. Using this valuation method for pensions is unique to Ukraine, and as a result, NPFs may be much worse off than the changes that participants actually see in their account values. The problem is straightforward to fix using simple universally applied accounting methods. To date most NPF administrators and asset managers have resisted all efforts

to remove or diminish their ability to manipulate account values of NPF participants.

As long as these erroneous accounting practices continue, it is entirely inappropriate for the government to channel mandated retirement savings to NPFs through mandated occupational pensions or Pillar II mandated accumulation accounts. The mandated savings would be at high risk of earning below market rates of return and being partially confiscated through manipulation.

The recession also underscores the weaknesses in the asset allocation limits in current law and suggests that pension participants could, and probably should, have an opportunity to select among alternative investment portfolios. However, movement in this direction is hampered in Ukraine by the incompetence of some service providers to pension funds. They do not seem to be able to master the technique for computing a single unit value, and they consider computing a unit value for different asset mixes unthinkable. Unit value accounting is used throughout the region, but some Ukrainian professionals refuse to conquer (or admit they could conquer) this simple international accounting procedure.

As the recession continues it may also reveal weaknesses in the regulatory structure and in the ability of regulators to enforce the law. Going forward the weaknesses must be corrected or they will continue holding back the development of Pillar III voluntary pension schemes. The enactment of amendments to the Law of Ukraine on Non-State Pension Provision (the bill is being prepared for the second reading) by the Verkhovna Rada would make it possible to rectify the existing drawbacks in the activities of non-state pension funds and contribute to their effective operation.

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