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INTERNATIONAL TRENDS: ECONOMIC CRISIS HIGHLIGHTS WEAKNESSES OF DEFINED BENEFIT SCHEMES

Non-solidarity pension schemes, in which workers' pensions are fully financed before they retire, are of two types : defined contribution schemes (DC) like Ukraine's pension funds and planned Pillar II, and defined benefit (DB) plans which are popular in Europe and the United States, especially with employer-based pension systems and with insurance companies offering retirement coverage. However, DB's popularity has been eroding in favor of DC: according to Watson Wyatt in a recent study on global pensions, DC assets now comprise 45% of global pension assets compared with 30% in 1998. The recession appears to further put DB pension schemes into question, especially since the recession is likely to be long lasting.

In contrast to a DC pension plan where retirement capital grows according to markets, in a DB scheme the amount of retirement income is set beforehand. In other words, the future pensioner knows how much retirement he will be receiving. The sponsor and the worker pay a contribution that is adjusted every year and this capital is then invested. The scheme's sponsor (often the employer) knows he has to build up enough capital to pay his workers' retirement for their lifetime. That's why the monthly or yearly contributions have to be reviewed on a yearly basis by an actuary according to a very complex valuation system. The sponsor has to make sure that he will have "grown" enough money in the end to meet the scheme's obligation (though in fact he doesn't know exactly how much he needs since the sum is subject to the beneficiaries' lifespan). Many countries demand that DB schemes be over-funded (like 105% in the Netherlands) to make sure there won't be a shortfall of assets when pay out time comes. Also, contributions have a tendency of going up when markets are down, like now. Although employers may be able to delay making higher contributions for a short time, they must increase their contributions soon. If they do not, the pension plan could become severely under-funded.

DB schemes may seem more attractive and reassuring than DC schemes where the final retirement sum depends on investment returns over many years. However, when the sponsor's financial



health is threatened, this security becomes illusionary. First, the employer will have a harder time making the contribution. Second, the contributions will put even more pressure on his finances.

That's why defined-benefit pension schemes are being seriously put to test by the recession, even spurring debate about the long-term viability of such schemes. USAID CMP Senior Pensions Expert Gary Hendricks points out that they are actually very risky: the sponsor bears the risk but the worker suffers the consequences if the sponsor goes bankrupt. Also, DB schemes are less transparent than DC accounts because the valuation is highly technical and not accessible to a non-specialist. In short, "workers can't really assess how well their pension scheme is doing. However, their DB scheme is just as vulnerable to market fluctuations as a DC scheme since the assets of both are invested on financial markets."

United Kingdom: Debating "Lifeboat Fund" Levy for DB Schemes

The U.K. Society of Pension Consultants has claimed that schemes of companies that are in financial distress should be granted temporary amnesty from paying the annual levy into the Pension Protection Fund (PPF), a "lifeboat" fund offering compensation to scheme members when the employer funding a DB scheme becomes insolvent. The PPF was set up in 2005 in response to growing public concern that members of DB schemes could be left without anything if schemes are under-funded. Besides offering compensation to those pension scheme members affected by insolvencies, the Government hoped that the existence of the PPF would improve confidence in pension schemes overall. The PPF is funded by the levy which also covers administrative costs.

U.K.: Pension Funds Warn DB Schemes in Danger

A study by the U.K. National Association of Pension Funds (NAPF), representing about 15 million members and 1200 funds, reveals that 96% of 100 schemes surveyed in January 2009 believe that the crisis has made the closure of defined benefit schemes more likely. NAPF says 52% of defined benefit schemes currently open to new members could close as a result of the economic crisis which puts excessive pressure on sponsors. On the members' side expectations are no higher. Confidence in such schemes crashed from 22% in September to 1% in January 2009. NAPF has proposed an action plan to try to save the DB schemes and their participants' pensions. It has suggested that the Government become the guarantor of the Pension Protection Fund (PPF).

U.K: Bankruptcies Put DB Pension "Lifeboat" under Pressure

The collapse of Lehman Brothers, retailer Woolworths, and now the telecom giant Nortel, all sponsoring extensive DB schemes in the U.K. is putting the country's pension lifeboat fund, the Pension Protection Fund (PPF) under financial stress. PPF is already covering the retirement incomes of the first two, and has now been asked to rescue the pensions of Nortel's 43,000 British participants. But as a result, the PPF itself will be suffering a shortfall in assets of up to £1bn (£500 million at present). According to an article in the

Guardian newspaper, the Nortel rescue came as the Moody's rating agency warned that "pension deficits posed a significant risk to U.K. corporations following a dive in share prices over the past year and a rise in the cost of funding pensions." Moody's also said that pension shortfalls were "the equivalent of debts and were an additional burden when many companies had come under pressure from banks to cut their debt."

Netherlands: DB Funds Granted More Time to Recover

The Dutch government agreed to give private pension defined benefit schemes more time to recover lost funds. Dutch minister of Social Affairs Piet Hein Donner announced that the mandatory period for pension funds to achieve their 105% cover ratio will be extended from three to five years, "due to the exceptional state of financial markets". While some funds are still reaching cover ratios above the required minimum of 105%, many funds are sitting at between 85% and 100% and may fall even lower, VB pension fund association warned. For instance, the two largest Dutch funds - ABP for civil servants and teachers and PFZW for healthcare and welfare workers - declared cover ratios of 90% and 92% respectively at the end of 2008.

WORLD RECESSION: NEW STRATEGIES EMERGE AS PENSION SYSTEMS ADAPT TO CRISIS

– Governments

U.S.: Obama Backs Automatic Offer of DC Retirement Plans

In his 2010 budget blueprint president Obama proposed that corporate 401k pension schemes offer automatic enrollment. This strategy is perceived as a step towards a reform of the U.S. pension system from a largely voluntary one to a mandatory participation by workers. According to the Government, the goal is to increase household savings by making saving easier and more attractive. President Obama plans to increase saving rates among lower paid workers by automatic enrollment in Individual Retirement Accounts (IRAs) and extending tax breaks for those saving into a retirement account. The proposal will include employees not already covered by a workplace pension saving scheme, with the option to opt out. Half the U.S. work force - about 75 million people - currently lack access to employer-based retirement plans. (pionline.com)

Sri Lanka: Major DC Pension Scheme to Allow Early Withdrawal

Sri Lanka's Employee's Provident Fund (EPF), the country's largest scheme and managed by the Central Bank, may allow partial withdrawals of balances. Up to now, private workers hit by high inflation created in the country by the central bank and the low comparative yield of the EPF have resorted to using a loophole for housing loans to make de facto withdrawals from their pension fund. Workers will be allowed to withdraw up to 30 percent of their balances after a membership of 10 years. Officials hope the early withdrawal



facility will reduce the incentive to borrow and default against fund balances. In 2008 the outstanding balance of the fund has grown 16.5 percent and the fund has earned about 70 billion rupees as income this year.

Germany: Government Plans to Raise State Pensions

The Government plans to increase state pensions to boost the spending power of Germany's 20 million retirees. It is the largest increase in 15 years, according to Bloomberg. About a quarter of Germans will benefit from higher pensions this year, mainly as a result of the country's economic growth from 2006 to 2008. They underline the benefits of Germany's pay-as-you-go welfare system. Germany's mandatory pension plan draws funds from gross pay and the federal budget. Budget woes and the rising monthly pension insurance led to three consecutive years of zero pension increases through 2006. Germany will pay more than 80 billion euros from its 288 billion-euro budget this year on pensions.

Kazakhstan: Pillar II DC Funds Straining to Increase Holdings in State Debt

Kazakhstan's pension funds are asked to purchase bad debt as part of a bank-bailout effort launched by the Government to attempt to stabilize the economy. The National Wellbeing Fund, a Government run organization that manages a bank support strategy has been trying to sell local-currency bonds to pension funds in order to collect U.S.\$5 billion to refinance banks. However, the \$9.5 billion pension industry that already holds 2.8 billion in bonds may not be able to absorb more of such securities. The country therefore may choose to sell Eurobonds, turn to China for extra funding, or to the IMF, as alternate ways to finance its bank bailout plan, Bloomberg reports. Kazakhstan's 36 banks are scheduled to repay an estimated \$10.5 billion to foreign investors in the 12-month period. (Bloomberg, Reuters)

– Funds

Global: Pension Funds Invest in Ethical Investments

Norway's government defined benefit pension fund adheres to strict investment guidelines banning investment into companies whose business or shareholders are considered unethical by a special council. The blacklist of excluded companies includes polluting mining companies, weapons producers and companies guilty of labor law violations. A U.K. organization, the Ethical Investment Research Service, screens the 7000 companies in the fund's portfolio on a monthly basis. In Norway, excluding tobacco companies is being discussed. There are currently 29 companies being excluded from the Norwegian fund, including some for causing pollution, others for manufacturing components of cluster weapons. Funds in Sweden and New Zealand have also thrown companies out of their portfolio for ethical reasons. Funds in emerging markets are also catching on: the Brazilian Pension Fund association adopted a set of guidelines encouraging funds to take environmental standards, corporate transparency and other criteria into account when considering investments.

Netherlands: Dutch DB State Pension Fund May Cut Benefits

PME, a major pension fund for employees of the mechanical, electrical and engineering businesses, says it may have to cut pensions by up to 10% next year to fulfill the 105% funding level obligation for defined benefit (DB) in the Netherlands. PME says it is preparing a recovery plan. All under-funded schemes need to file such a plan with the regulator by April 1.

U.K.: DB Funds Say Hedge Fund Investments Beneficial to Diversification

The U.K.'s second largest pension fund, the Universities Superannuation Fund with the equivalent of 33.4 billion U.S. dollars in assets, recently confirmed its plan to double its allocation to alternative investments including hedge funds to 20%, Reuters news agency reported. The West Midlands Local Authority Pension Fund which has U.S.\$9.25 billion in assets has allocated 8% of its assets to hedge funds and absolute return investments, despite this asset class' bad performance this year, as a means to further diversify its assets. The fund's CIO Judy Saunders told the agency that although the average hedge fund was in the negative last year, on a "relative basis they were actually stronger than quoted equities". Also the crisis has weeded out the hedge fund industry, leaving the stronger ones to improve practices, while the weaker ones have disappeared.

Mexico: DC Funds Agree to Invest Only Domestically

Amfore, an association grouping all pension funds operating in Mexico and representing a total of U.S.\$66 billion in assets, committed to investing assets domestically for the remainder of 2009. All new savings and interests from the funds handled by its members will be invested in local stocks, bonds and real estate investment in an attempt to boost depressed local markets. According to Reuters news agency, the agreement would not affect any investments already made in foreign stocks or debt, which amount to around 10% of the 925 billion pesos (\$66 billion) managed by Mexico's private pension funds as of the end of February. (Reuters, Bloomberg)

MARKETS: FUND PERFORMANCE

– Defined Benefit Schemes

Norway: Government DB Fund Sees Value Plunge

The Government Pension Fund has lost U.S.\$92 billion in 2008 due to the drop in equity prices but also government bonds performing less well than expected, the BBC reports. The value of the fund's equity – which represents half its portfolio – fell by one fifth, while bonds' yield rose only about 1.6%, failing to even out the losses. The fund's portfolio was "less well diversified" than expected the head fund manager Yngve Slyngstad admitted. The fund – worth U.S.\$330 billion – is the world's largest sovereign wealth fund after that of the United Arab Emirates. It actually comprises



two funds, one of which invests Norway's oil earnings internationally. Norway is the fourth largest oil and gas exporter worldwide. The "oil fund" itself saw its value rise, but mostly thanks to U.S.\$60.7 billion in revenue earned when oil and gas prices were at their highest last year.

U.S: Funding Ratios of U.S. Pension Plans Fall

Funding ratios fell by 6 percentage points on average in February and 32.3 points since the beginning of 2008. The drop in liabilities was relatively small in February at -0.6%.

U.S.: DB "Lifeboat Fund" Takes Responsibility for Madoff Victims

The Pension Benefit Guaranty Corp (PBGC), the U.S. corporate lifeboat fund, took on pension liabilities for members of a pension scheme that lost all its assets in Bernard Madoff's "Ponzi" fraud scheme. The East River Management Corporation which held a defined benefit scheme of U.S.\$2 million in pension liabilities was unable to pay benefits to 61 retired workers. The Pension Benefit Guaranty Corporation (PBGC) is an independent agency of the U.S. government created in 1974 and acts as an insurance of defined benefit liabilities, protecting 45 million workers. It is financed by insurance premiums paid by sponsors of defined benefit pension plans, assets held by the pension plans it takes over, recoveries of unfunded pension liabilities from plan sponsors' bankruptcy estates, and investment income.

– Defined Contribution Schemes

Results of pension investments can vary according to investment choices: some conservative portfolios with high bond exposure and low equity exposure have shown lower returns than higher risk portfolios but have suffered less from the crisis. In both cases, high risk or low risk long term logics of pension investments will even out the effect of the market pendulum.

Hungary: Funds Report -20% Losses

Pension Funds posted a -20% yield for 2008, compared to an average yield of +5.7% for 1999-2008, the Dow Jones agency reports. Funds allocated 60% of their assets to government bonds, generally considered a relatively safe instrument, but the devaluation of Hungary's currency led to a weakening of bonds. Hungarian stocks lost 50% on average. However, Hungary's regulator PSZAF said that these results were in line with global trends: Irish funds realized a -35% yield last year, and U.S. funds posted -22%.

South Korea: Investments in Bonds Protected State Fund

South Korea's "National Pension", the country's largest institutional investor covering self-employed and private-sector employees, limited losses thanks to a large bond allocation, the Government says. Though the fund's performance was barely positive with a 0.01% return on investment, it did surprisingly well compared to most pension funds worldwide posting negative returns. The fund has been

adhering to a conservative policy for years. It currently invests 77.7% of its assets in local bonds, with the rest put in stocks, foreign bonds and other alternative assets. Though it had ventured forward to riskier asset classes, the world economic crisis had it returning to safer instruments in the second half of 2008. The fund posted average returns of 6.1% between 2003 and 2007, which is just half of what large U.S. funds posted until the financial crisis sent many tumbling. (Financial Times, Bloomberg).

Germany: Funds Reduced Equity Prior to Crisis, Diversify More

German pension schemes have "weathered the crisis well" IPE.com reports quoting ABV, a pension fund association. The equity quotas in the portfolios had been reduced even before the crisis, in some cases as early as 2007. Quoting Mercer, a leading investment consultant, the publication reports that some pension vehicles had to reduce their risk exposure after their assets level dropped forcing them – by law - into safer investments. The publication writes others had assessed the market correctly and actively down-sized their holdings, and many already had plans to lower their equity exposure in order to be able to further diversify their portfolios. Diversification plans steer funds more towards investing in convertibles, rather than in equity.

Global: Schemes Under Pressure to Meet Private Equity Call

According to a report by Preqin consultancy, pension funds could have trouble funding private equity call-up obligations in the next twelve months. According to a survey, 6% said they might be unable to meet their obligations. However 92% said they did not expect any difficulties. The report says that 40% of polled funds said they had changed their allocation plans away from private equity, and 56% said they would "continue to invest in the asset class as normal". Of those investors that have changed their strategies, 17% said they would not make any further commitments to private equity.

France: BNP Cuts Staff in Pensions Team

BNP Paribas dissolved its pensions advisory team within its investment banking division, transferring pension market responsibilities to the corporate and institutional marketing and sales team. Last year Credit Suisse slashed its pension advisory team, and Swiss Re is also considering scaling back, Global Pensions reported.

Sweden: Pension Manager Executives Give Back Bonuses, Despite Passable Results

Senior executives at AMF, a leading pension manager, gave back bonuses they received for 2008: the executive vice-president returned the equivalent of about U.S.\$112,000, the CEO who had received about U.S.\$6,000 just one month after starting his job also returned his bonus. The pension manager posted a -6.6% return. However, it appears that an early cut in equity helped limit losses. Bonuses in the investment world have become a highly publicized and debated issue in Sweden. (globalpensions.com)



THIS MONTH'S ANALYSIS: ASSET VALUATION UNIVERSALLY FAVORS MARKET PRICING

Table : Pension Asset Valuations Across Countries

Most occupational pension systems in OECD countries use a valuation methodology based on the market value. In Latin America where compulsory regulations exist for the valuation of pension assets, these are mostly based on market prices

COMPARATIVE TABLE PENSION ASSET VALUATIONS ACROSS COUNTRIES

(Source : Antolin P. (2008), "Pension Fund Performances", OECD Working Paper on Insurance and Private pensions #20, OECD Publishing, p.8.)

Area	Country	Valuation Methodology
Latin America	Argentina	Market value except certain public bonds, which are valued at "book value".
	Bolivia	Market value.
	Brazil	Market value except certain bonds, which are valued at "book value".
	Chile	Market value.
	Colombia	Market value except certain variable income securities (equities), which are valued according to a liquidity index during the valuation date.
	Costa Rica	Market value except for those instruments which a period of maturity less than 180 days, where the valuation at market price is optional.
	El Salvador	Market value.
	Mexico	Market value. However, due to practical limitations (e.g. liquid markets), some securities are market-to-model.
	Peru	Market value.
	Uruguay	Market value.
CEE	Czech Republic	Market value except financial instruments held to maturity, securities of a collective investment fund of financial instruments not actively traded on a market, for which the valuation procedure is the average price of executed transactions.
	Estonia	Market value.
	Hungary	Market value.
	Poland	Market value.
	Kazakhstan	Market value.
North America	Canada	Market value.
	United States	Market value.
Western Europe	Netherlands	Market value.
	Sweden	Market value.
	United Kingdom	Market value.
Asia - Pacific	Australia	Market value.
	Hong Kong	Market value.
	Japan	Market value.

Source: Tapia (2007 a,b)

"Mark to Market" Principle Debated at Investment Conference

Mark-to-market accounting is 'not helping' pension funds during the economic crisis, Vice- chairman of Barclays Global Investors (BGI) Europe Lindsay Tomlinson said at a recent investment conference by the Association of Pension Funds (NAPF) held in London. Tomlinson pointed out that markets always over-react to any changes and referred to a book by Ben Graham "The Intelligent Investor" which describes the market as being subject to volatile mood swings between euphoria and depression. The use of mark-to-market accounting makes 'pension costs prohibitive' for sponsoring employers, he warns. Another consultancy, HSBC Actuaries & Consultants also said that mark-to-market is not considered to be reflective of an asset's valuation in current volatile market conditions. (ipe.com)

USAID Capital Markets Project Senior Pension Expert Gary Hendricks points out that "although valuing assets at their current market value may not always be an accurate assessment of "real" values in Ukraine, it has the distinct advantage of offering "a SINGLE rule for the valuation for ALL assets". By submitting" ALL funds to the same rule, fund participants can effectively compare the performances of different funds", he says, making valuation more transparent for the future beneficiaries.

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The USAID Capital Markets Project (CMP) was launched in October 2005, and is a five-year program designed to assist the country in developing a vibrant and effective financial sector. This effort will promote sustained economic growth and reduce the costs and risks to a sound pension system. You can find out more on the CMP website www.capitalmarkets.kiev.ua or on the website about pension reform in Ukraine: www.pension.kiev.ua

USAID's assistance focuses on the following areas: Economic Growth, Democracy and Governance, Health and Social Sector. Since 1992, USAID has provided \$1.6 billion worth of technical and humanitarian assistance to Ukraine to further the processes of democratic development, economic restructuring and social sector reform in the region. For additional information about this and other USAID programs in Ukraine, please call USAID's Development Outreach and Communication Office, tel. (044) 492-7101 or visit the USAID website at: <http://ukraine.usaid.gov>.