Functional Improvement of Non-State Pension Funds as Mechanism of Investment in Russian Economy

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Abstract: The article is dedicated to the search of investments in the domestic financial market that is a relevant problem for the Russian economy. The authors believe that pension funds attracted by non-state pension institutions are an essential resource for the Russian economy; practices of foreign pension institutions need to be examined and implemented to tap this resource more efficiently.

The proposed measures specified in the article following the study of foreign pension funds' functioning include: changes in the criteria for balancing portfolios of Russian pension funds' securities; development of new instruments for pension funds' investment; enhancing activities of non-state pension funds' shares market; activation of pension funds' investments in shares of innovative enterprises, etc. Practical proposals on the improvement of Russian non-state pension funds' activities have been made.

Keywords: Pension system, pension reserves, pension savings, portfolio strategy, portfolio structure, pension products.

I. INTRODUCTION

Balanced development of the internal financial market is a rather relevant problem for the Russian economy. "The reason for it are foreign investors leaving the Russian market due to a tense geopolitical situation after the introduction of a ban on refinancing loans for top Russian borrowers in developed capital markets. Today, the domestic financial market is a key source of financing for real sector enterprises. Its condition and development prospects identify financial sustainability and growth opportunities of Russian companies" (Teplova TV, 2015).

II. ANALYSIS AND RESULTS

The analysis of the Russian financial market structure indicates a significant domination of credit institutions' assets relative to GDP over the same indicator of other financial institutions.

Table **1** demonstrates the structure of the Russian financial market assets in percentage terms of the Russian GDP.

The analysis of the data presented in the table shows that the existing financial system is focused on the transformation of cash flows exclusively through the banking system with a specific feature – an increase in concentration and enhancement of state control through ownership mechanisms which impedes the development of private initiative. The presence of an insignificant share of non-credit financial organizations' assets and the domination of the banking system, which, in the meantime, does not provide a proper level of domestic lending, indicates insufficient sustainability of the Russian financial market.

Nevertheless, the data presented in Table **1** demonstrates the growth of the pension market. Non-state pension funds (NPFs) that are in charge of not only pension provision but have the most long-term investment resources which can be used efficiently to boost growth of the national economy, perform the function of financial institutions of non-state pension provision in Russia. It is worth noticing that despite a three-year moratorium on transferring insurance premiums to non-state pension funds (NPFs) for accumulation of funded pension, the indicated growth is observed due to the positive dynamics of pension savings' investment results and placement of NPF pension reserves which should be considered a positive trend in the Russian financial market.

The analysis of investment sums that are annually transferred for capital investments in public (municipal) property items presented in Table **2** demonstrates that these sums are comparable with frozen volumes of annual insurance premiums for the funded pension amounting to 370-400 billion rubles (Izvestia, 2016). The total volume of pension savings and pension

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Table 1: Structure of the Russian Financial Market Assets from 2012 to 2016 (Kulikova EI, 2018)*

Financial market participants	Assets, in % of GDP				
	2012	2013	2014	2015	2016
Credit organizations	79,6	86,8	108,7	99,7	93,0
Insurance entities	1,9	2,0	2,0	2,0	2,3
Securities market professionals	1,8	1,3	1,0	0,9	0,9
Non-state pension funds (NPFs)	3,4	4,1	3,9	4,5	4,8
Mutual funds	0,78	0,8	0,71	0,72	0,73

Authors' calculations based on data from information portals.

reserves in NPFs as of 31.12.2017 amounts to: pension savings – 4 326 057 mln. rub. (2 455 011 mln. rub. out of them are in NPFs); pension reserves – 1 184 069 mln. rub. (Invest funds information portal, 2018) which confirms the conclusion that pension funds are a significant resource for the Russian economy.

Table **2** shows the volumes of capital investments in public (municipal) property items across all ministries and authorities in the Russian Federation.

Further development of the Russian pension system for a more efficient use of pension funds' in the economy should be aimed at improving the competitiveness of non-state pension funds, increasing the degree of diversification of pension funds' investment, and expanding the range of products offered, which will ultimately increase the importance of the pension system in enhancing the sustainability of the Russian economy.

It is worth noticing that the Russian pension system today is characterized by certain features that prevent it from functioning effectively. They include:

1. multiplicity of pension market regulation entities, where the Bank of Russia, the Ministry of Finance of the Russian Federation and the Ministry of Labor and Social Protection serve as regulatory bodies simultaneously, which leads to a conflict of interests of various ministries in the pension market;

2. unregulated structure of citizens' ownership of pension savings and pension reserves, which results in inability to form their personal pension capital and also gives certain preferences to the banking system (funds in the bank account are the property of the citizen). Such situation leads not only to social passivity in terms of reforming the pension system, but also to the lack of the need to implement various investment strategies and the use of pension savings;

3. existence of funded pension being the only product offered by non-state pension funds in the sphere of compulsory pension insurance. This is explained by stringent requirements for quality (often unnecessary ones) and the ratio of assets included in the portfolio of non-state pension funds, uniformity of portfolio structure, etc., which reduces significantly the profitability of investment and restrains the creation of new classes of financial instruments for investing pension savings;

4. lack of conditions for attracting new institutional investors to the pension market to create competitive environment (participation in the management of banks' and insurance companies' pension funds) and, ultimately, increasing the profitability of pension savings, as well as reducing the cost of trust management services.

Table 2: Volumes of Capital Investments in Public (Municipal) Property Items in 2018 and Over the Target Period Until 2020*

Name of indicator	2018	2019 (target)	2020 (target)
Capital investments in public (municipal) property items, mln.rub.	613 850,3	484 160,0	427 518,2

Authors' calculations using the data from the Russian Ministry of Finance – budget breakdown.

Table 3: Structure of Pension Funds' Aggregate Portfolio in Eastern Europe (OECD Report, 2017)*

Country	Cash and deposits with credit institutions, %	Government and corporate bonds,%	Shares, %	Units of investment funds,%
Czech Republic	8	88	0	2
Estonia	23	18	3	55
Hungary	4	61	8	26
Latvia	13	47	1	38
Poland	7	10	**83**	0
Slovakia	10	64	2	19
Slovenia	14	62	1	21
Albania	3	**95**	0	0
Armenia	27	45	27	0
Bulgaria	14	55	15	12
Croatia	3	72	20	4
Republic of Macedonia	8	61	8	22
Kosovo	3	6	0	**92**
Lithuania	9	37	0	53
Romania	7	70	19	4
Russia	18	61	12	0
Serbia	14	77	7	0
Average value of asset's share in portfolio	10,9	54,6	12,1	20,5

Authors' calculations.

We assume that the analysis of foreign pension institutions' practices will be rather useful for the improvement of the Russian pension system. Structural comparison of portfolios built by pension funds in different countries is presented in Table **3** (countries in Eastern Europe) and in Table **4** (developed Western countries).

Analysis of the data in Table **3** demonstrates that the main instruments for investing pension funds in developing countries of Eastern Europe are government and corporate bonds.

Comparison of the data in Table **3** and Table **4** demonstrates that the aggregate portfolio of pension savings in the developing countries of Eastern Europe is less balanced compared to the portfolio of developed countries. In portfolios of pension institutions in developed countries, the share of investments in credit institutions' deposits and bonds is smaller; however, the share of investments in shares and units of investment funds is greater. We also like to note that in Russia, such asset as a unit of investment funds is practically not used as an instrument for investing pension funds which indicates that the investment potential is used insufficiently.

Differentiation of requirements to different types of portfolios may be also considered one of the features peculiar to the Russian pension system: a portfolio of government securities (Vnesheconombank management company – VEB), an expanded portfolio and a portfolio of pension reserves (private management companies and NPFs). It should be noted that the requirements for the pension reserve portfolio are quite liberal compared to the requirements for pension savings, moreover, the Bank of Russia has drafted the Instruction of the Bank of Russia "On requirements for the formation of the composition and structure of pension reserves ..." [Draft Decree of the Bank of Russia, 2018] with the following major innovations:

- changes in the structure of pension reserves connected with a decrease in investments in banks' deposits, as well as increases in asset limits, including those with an enhanced risk profile;
- the possibility of investing in new investment objects, such as units, shares and bonds of foreign issuers; extended list of real estate facilities; claim rights from life insurance

Table 4: Structure of Pension Funds' Aggregate Portfolio in Western Europe (OECD Report)*

Country	Cash and deposits with credit institutions, %	Government and corporate bonds,%	Shares, %	Units of investment funds,%
Austria	9	46	33	0
Belgium	3	12	9	72
Denmark	1	31	22	8
Finland	3	31	37	0
Germany	1	35	0	45
Greece	4	61	7	25
Island	7	48	16	18
Ireland	3	42	33	0
Italy	5	43	13	11
Luxemburg	3	44	0	50
Netherlands	0	25	14	53
Norway	2	41	15	36
Portugal	7	47	7	28
Spain	12	51	11	18
Sweden	1	17	15	62
Switzerland	4	14	9	56
UK	2	25	14	27
Liechtenstein	5	41	30	0
Average value of asset's share in portfolio	4,0	36,3	15,8	28,3

Authors' calculations.

contracts; share in the authorized capital of limited liability companies, etc.

The implementation of this statutory document will complement the range of strategies for building portfolios of Russian NPFs' pension reserves, expand the range of pension products and implement global practices in this area. However, this work will be focused more on pension savings, given that the amount of pension accumulations of NPFs is much larger than the volume of pension reserves, and legislative restrictions are much more stringent which makes the problem of increasing their profitability relevant.

Studying the dynamics of changes in the structure of the aggregate portfolio of Russian NPFs' pension accumulations (Figure **1**) suggests that it is extremely conservative.

It is obvious that initially the main share of pension savings was invested in bonds (state bonds, bonds of the Russian Federation constituent entities, corporate, mortgage bonds, etc.). Diversification of the aggregate portfolio began in 2008-2009. Most likely, this was due to the 2008 global crisis which made NPFs and private management companies (PMCs) realize the need for risk sharing between assets.

As mentioned above, the legal basis for the development of NPFs' securities portfolios imposes tough restrictions on the structure of the pension savings portfolio for the creation of a balanced portfolio. However, the experience of forming Western funds' portfolios shows that pension funds of shares comprising shares of companies in different industries, or companies of one industry, but located at various stages of the life cycle, or a composition of shares of various countries – developing (with greater profitability and volatility) and developed (more conservative securities) countries – have proven well. Two Australian pension share funds (Table **5**) are taken as an example of pension assets portfolio development.

We have chosen Australian funds because of high efficiency of the national pension savings system. Australia was ranked World's 1-st by total pension

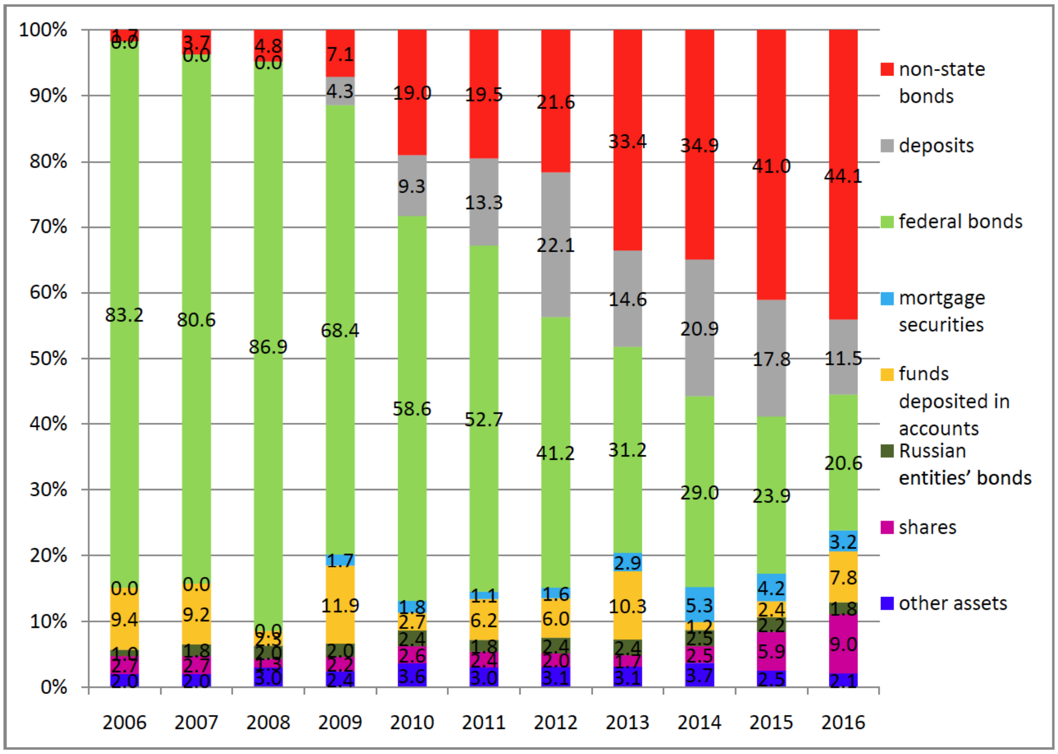

Figure 1: Changes in the structure of pension accumulations' aggregate portfolio in NPFs, VEB and private management companies [ANPF report, 2016].

Table 5: Indicators of Australian pension funds' structure *

Pension fund: ANZ OA TAP-Arrowstreet Global Equity (Hedged) NEF		**Pension fund: ANZ Flexible Income-Property Securities**	
Proportion of shares by industry, %			
Information Technology	18,76	Retail	48,09
Financials	16,43	Diversified	28,75
Industrials	13,7	Industrials	7,12
Materials	13,61	Others	6,13
Consumer Discretionary	12,26	Cash	5,28
Consumer Staples	8,1	Offices	4,63
Energy	7,19		
Shares countrywise, %			
North America	52,72	Global (Emerging)	33,65
Europe (ex UK)19,02		North America	24,7
Japan	9,07	Europe (ex UK)	17,5
Global (Emerging)	6,39	Japan	9,3
Asia Pacific (ex Japan)	5,76	Others	8,25
United Kingdom	4,71	United Kingdom	5,9
Others	2,33	Asia Pacific (ex Japan)	0,7

Data received in Thomson Reuters Datastream information system.

funds' assets to GDP ratio in 2016. (OECD report, Table **1**). Having studied 283 Australian pension funds, we've chosen the funds that have demonstrated rapid growth of pension funds' assets since the beginning of 2018 (ANZ OA TAP-Arrowstreet Global Equity (Hedged) NEF, 8.51%) as well as those showing slow growth (ANZ Flexible Income-Property Securities, 0.19%).

The analysis of the data presented in Table **5** indicates the following differences in portfolio structure of the pension funds in question:

1. The sectoral structure of ANZ Flexible Income-Property Securities pension fund portfolio is dominated by retail shares – 48%; almost one third of portfolio is diversified as it is presented by a multisectoral set of shares; the rest of the portfolio is evenly distributed between monetary funds and other investments;

2. One third of the capital is invested in shares of emerging markets – 33,65%; securities of the developed countries in North America and Europe make up a significant part of the portfolio – 42%; one quarter of the capital (24%) is distributed between other countries almost evenly.

3. ANZ OA TAP-Arrowstreet Global Equity (Hedged) NEF pension fund portfolio has the following features:

4. The portfolio is balanced by sectors, the biggest investments amounting to 19% of all fund's assets were made in IT;

5. The main proportion of shares in the portfolio are shares of North American companies – 53%; shares of European enterprises make up 19%, securities of companies in other countries are distributed almost in equal portions.

As indicated above, Russian NPFs in compliance with the existing legislation are prohibited from building pension savings portfolios from shares only, especially those by foreign issuers, as well as prohibited from diversifying the portfolio using the criterion of developed / developing markets. However, there is still certain liberalization in terms of investing pension savings in various assets. Thus, the Russian Government Decree 824 as of July 12, 2017 and the Bank of Russia's Regulation 580-p on restrictions on investing pension savings of non-state pension funds (NPFs) and military mortgages under management of management companies expand the list of investment instruments. The indicated statutory documents make it possible to invest pension savings in shares in the course of IPO / SPO on Russian exchanges, invest no more than 5% of funds in start-ups through the exchange mechanism. Pension savings can be invested in shares of Russian joint-stock companies listed in the RII-Prime segment of ZAO MICEX Stock Exchange, i.e. in shares of small high-tech, fast-growing companies entering the IPO. We assume that it will provide financing for the issuing companies, and moreover, increase the high-yield part of the portfolio if the startup turns out to be commercially successful.

III. CONCLUSION

Thus, in terms of financial instruments in which pension savings and pension reserves can be invested, the Russian pension system takes into account global trends in its development, which is manifested in the adjustment of legislation towards liberalization of non-state pension funds' portfolios. We assume that the specified legislative innovations should serve as a basis for expanding the line of pension funds' products.

From this point of view, Western foundations demonstrate interesting trends in the development of pension products. One of the world leaders in asset management – the American company Vanguard – has a special line of funds targeted for pensions. For example, Vanguard Target Retirement 2025 Fund – is a fund aiming at clients who will retire in 2025. The Fund's structure corresponds to this age group and refers to the "balanced" category. Now, Vanguard product line includes 10 target funds with a 5-year interval up to 2060 [Loginov V., 2017]. These funds enjoy sustainable demand and represent a growing market segment. It is obviously convenient for the future retiree – one can calculate the number of years to retirement and select the appropriate fund whose structure will change automatically while approaching the pension.

Individual retirement accounts (IRA) are popular in Western countries: American accounts – IRA; Canadian accounts – RRSP, Japanese accounts – NISA. It is worth noticing that not only pension funds and management companies but also financial holding companies, banks, mutual funds, insurers and brokerage firms serve as providers of these accounts. In April, 2017, a new type of individual saving accounts was introduced by the UK government – LISA (Lifetime Individual Savings Account). These accounts can be defined as "life cycle" accounts featuring a built-in mechanism of state co-financing and tax incentives for interest, payments and capital gains.

Since 2015, Russian citizens can open individual investment accounts (IIC) that have proven well in the financial market and that are becoming more and more popular. This mechanism may also be used for pension savings. We believe that this mechanism of savings can be modified in order to introduce new pension products similar to those existing in the Western market.

Thus, the study of Western practices of pension systems functioning allows using this experience to develop new pension products, increase the number of financial institutions offering these products to clients, create new strategies for diversifying pension savings portfolios and, ultimately, contribute to the creation of a reliable and competitive pension system in Russia.

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