What is... a pension fund?

BANKTrack

A pension fund is established by a company, governmental institution or labour union to pay for the (future) pension benefits of retired workers. Pension funds collect retirement savings from workers and their employers, and invest this money in a wide range of assets. Because pension funds manage the money of up to millions of individuals, they are major players in the financial markets.

Organization of pension plans

Most pension plans are organized as "defined benefit" schemes, by which a fund promises future retirees a certain amount of money per period. Pension fund managers have to make detailed calculations on how much they will be required to pay out to pensioners. There are several things they need to take into account:

- In most industrialized countries, current employees pay for the benefits of current pensioners. These pension systems are called "pay-as-you go". Pension fund managers thus have to estimate how long people will continue to work, how long they will probably live, and how many people will be working in next decades.
- A worker's benefits are normally related to his/her salary, either at the point of retirement or as an average over his/her work history.
- Often, pension benefits also need to be "indexed", i.e. rise along with the general price level or with the income levels in the respective sector. Fund managers thus also have to take future income level developments into account.

On the basis of these data, pension fund managers try to ensure that the rate of return on their portfolio investments equals or exceeds the anticipated payout need. If investments fail to provide the money needed to pay pensioners, the pension contributions will have to increase, or the benefits cannot be fully paid.

The level at which a pension fund can cover future liabilities is called the "asset liability" or "funding ratio". A higher ratio signals that the fund is in a healthier position.

The second way that pension funds can be organized is through a "defined contribution" scheme. In this arrangement, the worker is primarily responsible for saving for his/her own retirement. The employer usually offers a range of mutual funds (also known as "unit trusts") that the worker can use as a retirement savings vehicle. Typically in this scheme, the government allows workers to put money into their chosen mutual fund(s) before their salary is taxed, and the employer also contributes to the fund(s). Defined contribution schemes rely on the direction and discipline of individual workers, and are becoming increasingly popular in the industrialized world.

Pension fund investments

Pension funds invest their money in a wide range of assets. Pension fund staff sometimes manage the investment portfolio directly, but often they delegate their investments to a professional asset manager or investment firm. In most countries, the government regulates pension investments. For example, pension funds may not be allowed to invest more than a certain percentage of their portfolio in equity investments (see below). Representatives of employees and employers also often have influence on the fund's investment portfolio.

Pension funds differ in terms of what assets they invest their money in, and how speculatively they operate. In general, pension investments fall into two categories:

1. **"Fixed income" investments.**
   Fixed income assets promise a fixed return at a certain point in time. They are thus the most reliable, but their returns are limited compared to the possible returns on equity investments. The most common fixed income investments are government bonds and corporate bonds (from creditworthy governments and companies).
2. **Equity investments.**
   These investments involve the purchase of assets that makes the holder a partial proprietor of the asset. Real estate, i.e. buildings and pieces of land, can be a form of equity investing that is normally quite reliable, since building and land prices on average are stable over the long term. However, the

Biggest Pension Funds worldwide

Ranking	Name	Country	Total Assets (US$ million)
1	Government Pension Investment	Japan	290,991
2	ABP	Netherlands	142,084
3	California Public Employees	U.S.	128,678
4	Local Government Officials	Japan	101,020
5	Federal Retirement Thrift	U.S.	96,020

2002/2003 figures. Source: Pensions & Investments/ Watson Wyatt Global 300 Survey

returns are limited compared to other forms of equity investments like shares in companies, mutual funds and hedge funds. Company shares give holders a share in the company and its profits. Mutual funds and hedge funds enable the investor to invest in a broad portfolio of different assets.

Trends & critical issues

- **Dominant players on the market**. Because of their immense size, pension funds' investment decisions have major influence in financial markets. For example, their role has helped create high share price bubbles. Once stock markets start to fall, pension funds will often try to reorganize their portfolios, which can contribute to the rapid decline in share values.
- **Huge losses.** In many countries, including the UK or the Netherlands, regulators do not restrict pension funds from investing heavily in the equity market (unlike in Germany). This means that large portions of Dutch and British pensions have been invested in company stocks. With the fall of stock markets at the end of 2001, pension funds lost billions. As a result, some funds have had to tell their beneficiaries they will raise required pension contributions and/or lower the pension benefits (or not index them). Supervisory authorities have had to intervene to force pension funds to come up with strategies to ensure all future payment obligations.
- **Scandals at investment banks**. During the stock market crisis, pension funds lost significant amounts of money. Some of the funds claimed that these losses were due to mismanagement of investment firms. Some firms, for example, were accused of misleading pension funds. As a result, there have been lawsuits, and some pension funds have managed to get some of their lost money back.
- **Little attention to sustainability issues**. Because pension funds are heavily regulated to ensure proper care over worker assets, pension funds have traditionally only been concerned about their portfolio's rate of return, and less concerned about investing in companies that are considered socially or environmentally sustainable. In the Netherlands, for example, only 1% of pension funds' money is directed to sustainable investments portfolio. However in recent years, some pension funds in Europe and the US have become increasingly concerned about climate change.

CSR Issues:

Pension funds are beginning to pay some attention to sustainability issues, often due to pressure from the public and/or their beneficiaries. Given the huge amount of money pension funds invest on financial markets, pension funds could play an important role in capitalizing sustainable investments.

However, pension funds are unlikely to invest exclusively in socially and environmentally sustainable companies. First, their commitment to a guaranteed rate of return makes them less flexible than other funds. Second, given their size (some are large enough to be considered "universal investors," which invest in the entire economy), there may not be a sufficient number sustainable companies available to invest in. Finally, given the large amount of money pension funds may have invested in a company, it is probably not desirable for pension funds to suddenly withdraw these monies out of companies that are perceived as less sustainable, as this could provoke massive problems for those companies and their employees. Using their shareholder power to advocate for more sustainable corporate behaviour is likely a more feasible approach for pension funds.

In addition, important regulatory steps can be taken to facilitate more sustainable pension investing. For example, changes in prudential regulation of pension funds may allow pension funds to have more options in sustainable investing. In addition, pension fund beneficiaries could be given more choice or voice in advocating for different types of investments. Indeed, in many countries there is hardly any transparency as to what companies pension funds own. In recent years, some progress has been made in this respect. For example, some industrialized countries like the UK (2000), France and Germany (2001) and Belgium (2004) introduced transparency regulations that require pension funds to report on whether they have ethical investing policies.

Glossary:

Fixed-income investments: with this form of finance, the financiers lend money to a company, government or specific project. This can be in the form of a bond or a loan. The returns of the loan and bonds are normally fixed in terms of their return.
Bonds: promissory notes that oblige the issuer to pay back a certain amount of money within a certain time (with or without regular payments, or 'coupons').
Equity investment: in this form of finance, investors become a partial owner of a company, project or piece of property. This can take the form of, for example, a company stocks or real estate. Financial returns depend on the success of the firm or the specific asset.

This fact sheet was produced by SOMO, centre for research on multinational corporations -www.somo.nl- for BankTrack, the campaigners network tracking the private financial sector.
T: +31-30-2334343, F: +31-30-2381112, E: coord@banktrack.org, www.banktrack.org