INVESTMENT TRENDS OF LATVIAN PENSION FUNDS AFTER THE 2008 FINANCIAL CRISIS

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Abstract
Investments are one of the most essential drivers of economic growth; without the investments no economic processes are possible. In this respect, not only investments in development projects of national significance, entrepreneurship and infrastructure but also in promoting the wellbeing of every individual and household are important.

Pension schemes may be attributed to specific investment services.

With the changes caused by the financial and economic crisis of 2008, considerable changes took place also in financial markets and uncertainly increased in the business and investment environment. The changes in the global financial markets were caused by bankruptcies of banks and other financial institutions as well as the implementation of bank rescue plans in many world countries, including Latvia. Recovery trends are increasingly observed in the global economy, and Latvia’s economy returned to growth in 2011; yet, there is still significant uncertainty over economic prospects, mostly in the world’s developed economies.

After the financial crisis, Latvian pension funds have reduced investment in risky assets, such as equities, and increased investments in fixed income and alternative assets. The distribution of investments by the private pension funds has changed fundamentally. The contribution of the private pension funds to the Latvian economy has impressively shrunk.

Keywords: pension fund, investment decisions, portfolio choice, financial crisis

JEL codes: G110, G010

Introduction
One of the founders of modern economics J. M. Keynes has said: “Nothing is more dangerous than a rational investment policy in an irrational world”. Individual investors tend to do the same mistakes, i.e. repeatedly make investments in wrong assets, which considerably harm their financial wellbeing. By applying Prospect Theory developed by Nobel Prize winners D. Kahneman and A. Tversky, scientists have found that under the circumstances when an investment result is uncertain, investors place too much focus on short-term changes in the value of their investments – increases or decreases – instead of the total value of their assets.

A considerable contribution to researching pension system issues at global level has been made by Axel Börsch-Supan. His research investigations focused on micro- and macroeconomic effects on the aging of the society and related problems as well as on pension system reforms in the world. In Latvia, important research studies on pension system-related problems at national-level were done by E. Volskis. He researched pension system enhancement problems in Latvia. Besides, it has to be mentioned that his research findings were appreciated at European level as well.
The year 2008 featured a significant turning-point in the field of finance, including the pension system and its stability. Hwang Wonhee has researched the investments trends of leading pension funds in the world before and after the global economic crisis of 2008. The research aim of the present paper was defined based on an examination of the research findings and the current situation.

The aim of the present research is to examine the investment trends of Latvian pension funds after the financial crisis of 2008.

The research object is the investment portfolios of Latvian private pension funds.

An excessive wish to avoid risk makes investors focus too much on limiting losses instead of making gains. Insignificant losses are perceived much stronger than profits of the same size. Consequently, due to such a nonlinear perception, mistakes in making investments are made and the best possible result is not achieved.

One of the most important stability indicators of the national economy is private pension assets or the 3rd pillar of the pension system that safeguards individuals against income decreases after their retirement and maintains their desirable standard of living during their retirement.

The crisis has revealed the importance of the European approach to pension systems. It has convincingly demonstrated the interdependence of the various pension pillars within each Member State and the importance of common EU approaches on solvency and social adequacy. The crisis has also underlined that pension funds are an important part of the financial system.

Pension funds face a number of risks that could not be influenced by their investors. The key financial risks are as follows: market risk, credit risk and liquidity risk. The management of a pension scheme’s funds is based on an assumption that any financial market is unpredictable; therefore, opportunities are sought for concerning how to effectively manage the risks, to reduce them as well as to avoid potential losses. Risk management is done according to the structure of an organisation and the responsibilities, duties and rights assigned to every unit of the organisation.

A detailed examination of the research object was performed based on a broad literature review and employing the monographic method. The investment trends of pension funds in the world were examined employing logical analysis.

Statistical data provided by Latvian commercial banks, the Financial and Capital Market Commission and the State Social Insurance Agency served as the information basis for the present research. Some numerical data were acquired from experts and by using news agencies and internet resources. The methodological framework is comprised of research works on pension systems by national and leading international scientists.

**2008 – The losses of the pension funds reached 10%**

In Latvia, private pension funds offer 3rd pillar pension system services; yet, savings for retirement may be additionally made by investing in life insurance with savings or other financial instruments. The 3rd pillar of the pension system was introduced in July 1998.
As of the 31st of December 2008, six private pension funds were functioning in Latvia: five open (daughter companies of Latvian banks) and one closed pension fund. At the end of the reporting period, six private pension funds offered 19 pension schemes.

At the end of the reporting period in the comparison with the end of 2007, the volume of assets of the private pension funds increased by 1% and was equal to EUR 1.7 million. In total, in 2008 the private pension funds were functioning with EUR 78.1 thousand losses (four out of the six private pension funds ended the reporting period with losses).

At the end of the 4th quarter of 2008 in comparison with the fourth quarter of 2007, the assets of the pension schemes increased by 15.8% and reached EUR 115.1 million. The distribution of the assets of pension schemes remained similar to that in the previous reporting periods. A considerable part of the assets was invested in debt securities and other securities with fixed income – 42% of the total assets of pension schemes, and such a type of investments totaled EUR 48.5 million as of the 31st of December 2008. In the reporting period, the volume of investments in term deposits of credit institutions, as well as claims on credit institutions continued to increase, reaching 41% or EUR 47.1 million as of 31st of December 2008. At the end of 2008, the share of investments in investment certificates of the investment funds was 15% of the total assets or EUR 16.8 million, and in comparison with the end of 2007 it was a decrease of 40%.

In total, the volume of the investment portfolio of pension schemes was EUR 105.7 million as of the 31st of December 2008.

Foreign investments made at the end of 2008, in comparison with the end of 2007, decreased by 8.5% and amounted to EUR 38.8 million. EUR 66.9 million were invested in Latvia, 8% of the investments were made in Luxembourg, 2% in Finland, 1% in Estonia, 4% in France, 5% in Germany, 2% in Russia, 3% in Ireland and the remaining 11% were invested in 21 states that issued securities. Of the total investments abroad, 95% were invested in the European Union Member States. (Finansu kapitala tirgus komisija, 2008)

A considerable share of assets was invested in debt securities and other fixed income securities – 27.8% of the total assets of pension schemes. Such investments totalled EUR 44,752 thousand as of 31 December 2011, while investments in term deposits at credit institutions comprised 22.2% of the total assets of pension schemes or EUR 31,591 thousand, which, compared with the end of 2010, showed a decrease of 20.8%. At the end of 2011, the proportion of investments in certificates of deposit by mutual funds totalled 49.0% of the total investment assets or EUR 79,086 thousand; compared with the end of 2011, it represented a 12.1 percentage point increase.

Investments made in Latvia decreased by 8.7%, and their total amount reached EUR 63.74 mln, comprising 39.6% of the total assets of pension schemes (45% in 2010). Most of the investments in foreign countries (95.2%) were made in the European Union, including Luxembourg (38%), Ireland (17.8%) and France (14.3%) (Finansu kapitala tirgus komisija, 2011)

2012–2013 – The assets of the pension funds increased – both in terms of new contributions and in terms of incomes

The year 2012 was very favorable for investors in global financial markets regardless of problems both in the political and in the economic arena, which made analytical work for asset managers more difficult but also more interesting. The investment risks in stock and bond markets yielded positive results. Within a year, investor concerns about an uncontrolled
European debt crisis decreased. The European Central Bank and the central banks of the USA, Great Britain and Japan made important steps, strengthening and expanding “quantitative stimulus” measures to assist their economies. Against a complex global background, Latvia was one of a few countries whose credit rating was increased and its economic outlook was affirmed positive.

2013 was characterized by the fact that the developed countries formed significantly different trends in the markets of securities. Several major developing countries, including Brazil, India and Russia, lost a status of favourite among investors. In the financial markets it resulted in the decrease of prices of state shares and bonds. The biggest losers – the bonds of developing countries – ended the year with a negative result at a rate of 5.6%, as well as the MSCI Emerging Markets Share index value fell by almost 5.0% during the year. The share markets of developed countries in 2013 ended on a positive note. The MSCI World index value showed a considerable increase at a rate of 17.5% recalculated in the Euro currency.

A comparison of the classes of return on assets during 2013 showed that the best indicators were able to reach the returns on the risk assets of developed countries, including shares and bonds of high credit risk.

In countries such as the USA and Germany, the investment rates of return on long-term government bonds declined for several decades, while the year 2013 could mean the beginning of opposite long-term trends.

If seeking a low credit risk, investors still have to deal with the risk of interest rate. For example, low interest rates on German government 7 to 10 year bonds. The year was not easy for the Latvian domestic bond market as well.

The distribution of investments in 2013 did not change dramatically. The major component of the total assets of pension schemes was fixed income financial tools – bonds and bank term deposits.

However, 25% of the total assets of active pension schemes formed the assets invested in the share market that also had a positive effect on active pension scheme returns in 2013.

Nevertheless, the 3rd pillar in the geographical distribution of pension investments was oriented both to the investments in Latvia (38% of the total pension scheme assets, which increased by 5% points in 2013) and to the investments in Western Europe, where the proportion of investments increased by 10% points, up to 31% of the total volume of assets. In addition, the proportion of global investments increased by 15% points, up to 11% of the total assets. (Finansu kapitala tirgus komisija, 2013)

**The Latvian pension system – the ninth more sustainable in the world**

In 2014, the accumulated pension capital value in the private pension funds increased by EUR 45.1 million or 19% and reached EUR 280.7 million. The increase in the pension scheme assets was influenced by the contributions of participants (EUR 5.1 million), the paid-up capital by the participants (EUR 15.4 million) as well as the gain from investments (EUR 9.4 million). At the end of the year, on average, the income of all private pension schemes per year was 5.33%, which was a high rate. Higher risk investments provided a better result; therefore, the highest income was provided by active pension schemes – 6.62%, while balanced schemes had a little bit lower return at 4.91%. (Finansu kapitala tirgus komisija, 2015)
According to the data of the Financial and Capital Market Commission, at the end of 2014 in Latvia the 3rd pillar of the pension system formed 234,985 participants or 18.8% of the number of participants in the 2nd pillar. The accumulated pension capital value amounted to EUR 280.7 million. All the pension schemes, on average, yielded 5.33% per year. Of the total assets, 33% were invested in Latvia (the Financial Capital Market Commission).

The year 2014 provided great income – over 5% – for the future savings of pensioners funded by the state and private pension funds. Amendments to the legislation made during the year have expanded the opportunities to invest pension funds in Latvia and the return on the funds is associated with the remuneration of the fund manager, as well as the payment system of private pension funds was enhanced as well. Increasing the investment limit will provide an additional opportunity in Latvia to form alternative investment funds based on local investment pension schemes, for example, to invest in forest and agricultural lands, energy efficiency or in other important fields for the Latvian economy, while creating good potential to achieve an adequate return on investment for the schemes’ participants.

The Latvian pension system as a whole, in the last year, was recognized by the international financial services company Allianz Pension Sustainability Index as the ninth most sustainable among 50 developed countries in the world and got the highest score among the countries of Eastern Europe. The Australian pension system was recognized as the most sustainable in the world, Sweden ranked in the second place and the New Zealand pension system ranked third. The Estonian pension system ranked in the 11th place, while Lithuania was in the 18th place. (2014 Pension Sustainability Index)

The research of Allianz was carried out analyzing the demographic situation of the state, the model of the pension system and its sources of financing. The research concluded that over the last 20 years the reforms carried out in the social security field have adopted the extensive changes also in the content and formation of the pension system. The first pillar pension system gradually replaced the funded tools, for example, pension funds and endowment insurance products, and direct state pension schemes came instead of individual contribution volume-based pension schemes. In comparison with the previous research, which was carried out in 2011, Latvia managed to improve its positions by two places.

2016 – The 20th anniversary of the Latvian pension system

Taking into consideration the unstable political and economic situation in 2015, the investments in Western European markets decreased by 4% points but slightly increased in global markets. The share of investments in the Latvian economy has remained almost unchanged – it decreased by only 1% and reached 32% of the total assets. (Finansu kapitala tirdus komisija, 2015)

In 2015, the average age of participants in pension schemes from 45 to 47 years. This fact is disappointing because it shows that more and more old people apply for participation in the 3rd pillar.

The percentage distribution of the 3rd pillar assets slightly changed in 2015 in comparison with the previous year. The investments in stocks decreased by 2 percent-points: up to 9.7% of the average assets for balanced pension schemes and 32.5% for active pension schemes. At the same time, money savings increased by 2 percent-points: up to 14.2% of the average
assets for balanced pension schemes and 11.2% for active pension schemes. As before, at least 90% of the assets were invested in the euro currency.

In 2016 when Latvia’s pension system celebrates its 20th anniversary, after analysing the performance of private pension funds from 1998, one can find that 25% of the economically active population or 261,925 participants started making investments in private pension schemes. However, only 6% of the economically active population participated in pension schemes through their employers.

Of the total pension scheme participants, 79% were private persons who made their investments themselves, while 21% or 55,542 were enterprise employees whose contributions were paid by their employers (Latvijas komercbanku asociacija, 2016)

The total assets of private pension funds, EUR 340 mln, accounted for only 5% of gross domestic product. Such a rate may be viewed as low, as not a single voluntary system for making long-term savings has ensured social support for the majority of the public in their old age. Furthermore, unlike in other EU Member States, Latvia’s government institutions have no right to integrate private pension schemes into their pay systems.

In Latvia, unfortunately, quite old individuals participate in private pension schemes, rather than those who recently began their careers and for whom it is easier to make monthly contributions, which are usually smaller. Achieving a situation when everyone beginning his/her career starts participating in private pension schemes might take, most likely, a long time – after several generations have changed – if their participation remains completely voluntary. To stimulate savings, amendments to legal acts have to be made just as it is currently done in a number of West European countries: employee pay has to include not only a wage and salary but also contributions to private pension schemes. The OECD too has given such a recommendation to Germany, the social system of which greatly depends on the principle of solidarity of generations or of auto-enrolment. However, Great Britain has introduced the auto-enrolment system before a number of years and achieved a situation that 90% of employees make investments in private pension schemes in addition to state social insurance contributions.

**Conclusions and discussions**

After the 2008 crisis, the distribution of investments by the private pension funds has changed fundamentally. The contribution of the private pension funds to the Latvian economy has impressively shrunk. According to the FKTK data, in 2008 the proportion of investments in Latvia made up 63.3% of the total assets, while at the end of 2015 it reached only 32%.

The largest obstacles to investing in Latvia’s company stocks faced by pension funds are the lack of investment opportunities and the low liquidity of the stocks traded at the stock exchange. One of the potential ways how to improve the situation involves starting quoting the shares of large state companies. This would create attractive investment opportunities for pension funds in Latvia and, potentially, in the Baltics.

The financial instruments presently available in Latvia are attractive enough, including for domestic pension fund managers. However, their assortment is very limited. For example, competition for government bonds during an initial public offering was very tough. However, pension fund managers would wish much greater opportunities. The demand for recently emitted Latvenergo bonds was high, and the pension fund managers positively viewed the
situation that such an additional opportunity appeared. Besides, pension funds could be invested in infrastructural and other projects of national significance as well.

The more attractive investment opportunities, the greater share of available finances pension funds can use for investment in Latvia.

This is a way how many countries have strengthened their long-term development. To date, the government’s investments in pension funds made from its social budget were perceived as an item of expenditures, which may be easily “cut” in case of problems. However, the funds accumulated in pension funds should be also perceived as an item of expenditures on development because it is possible to raise the standard of living in the country, support businesses and simultaneously form an efficient social protection and pension system if effectively using the funds of the pension funds. Of course, prohibiting making investments abroad by administrative measures is not possible. For example, Poland has already tried it, wishing to maximally support its economy by means of its population’s pension capital. The case ended up at the Court of the European Union that ruled that Poland had violated the basic principles of free capital movement within the EU market and such limitations had to be cancelled.

It is important to remember that the task of a pension scheme manager is to work in the interests of pension scheme participants. This, in its turn, means that the task of the manager is to seek for better and more attractive investment opportunities both in Latvia and in other countries. Consequently, it is necessary to diversify investment risks among several countries and investment categories. The funds invested outside Latvia are mainly invested in the EU Member States. A small share is also invested in the USA and emerging markets. The investments are made in foreign stocks, funds as well as bonds.

Unfortunately, political will, which is still lacked, is required for developing the domestic capital market and creating a diversity of financial investment opportunities. Politicians are reluctant to sell or at least reduce the state-owned share of large companies; they also avoid making important decisions that would seem favourable for the financial industry – the “financial feast” before the severe economic crisis and the selfish attitude of banks to their clients are still alive in human memory.

However, the amount of money increases and problems regarding investment opportunities for the money become more urgent. For this reason, Latvia has no choice other than creating competitive and interesting investment opportunities for pension capital managers if the country wishes the growing and guaranteed capital stays in Latvia as much as possible.

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