



# Challenges for the Icelandic pension funds: Investment opportunities

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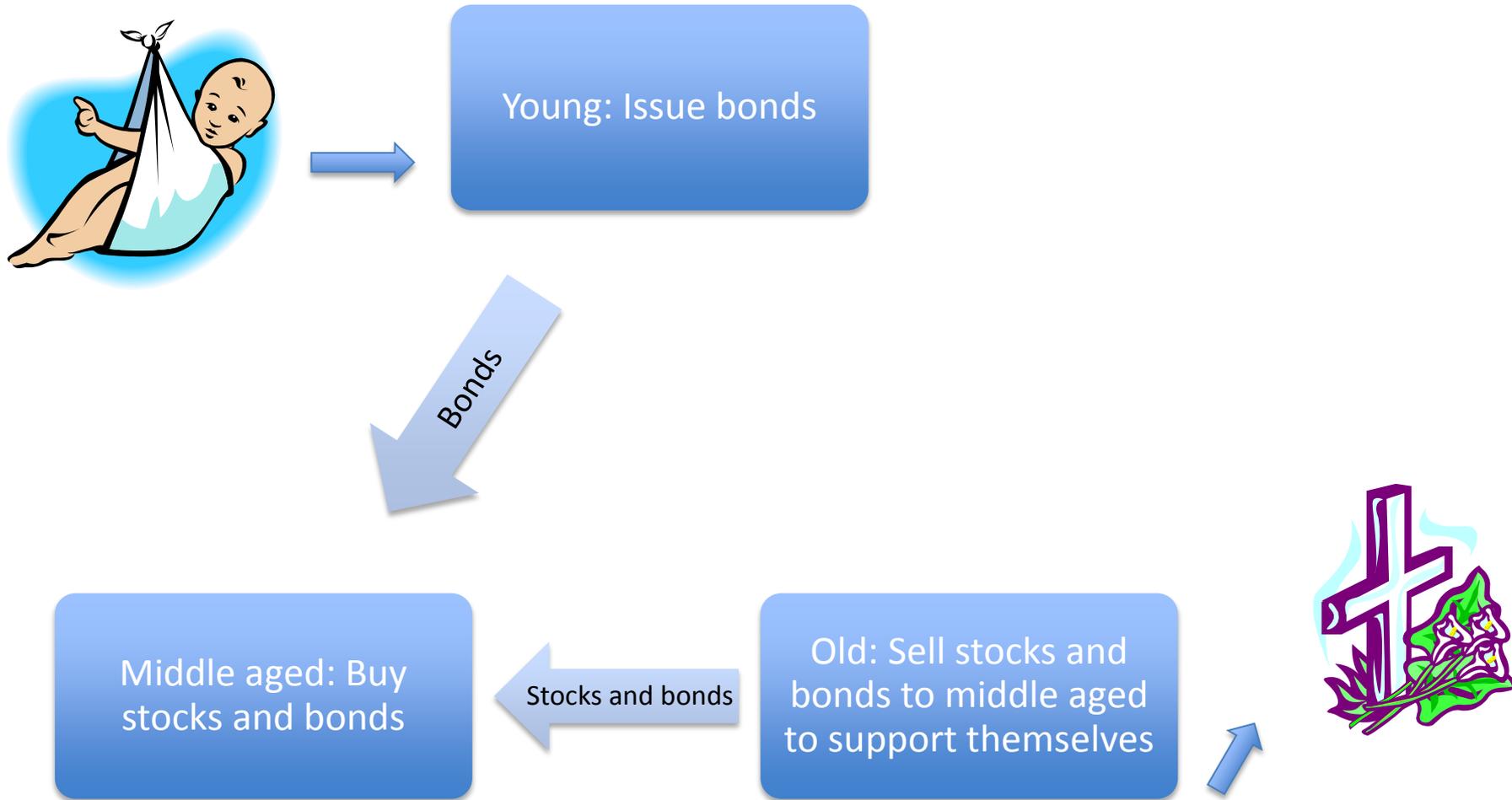
# Investment framework

- Article 36 of the law on pensions in Iceland determines what type of assets pension funds can invest in and how much they can invest in individual assets and asset classes (quantitative limits).
- This article has been amended several times and is now fairly complicated and hard to decipher.
- Changes are needed, both to clarify the article and react to a fundamentally changed financial market with a fairly limited supply of domestic financial assets and capital controls.
- The optimality of the approach used (quantitative limits) is also up for debate.





# Intergenerational trade in a fully funded pension system





# Intergenerational trade in a fully funded pension system

- A fully funded pension system requires a large stock of financial assets that can be used for intergenerational trade.
- A pay-as-you-go system relies far less on financial assets – basically some cash would be sufficient.
- The Icelandic system now suffers from a lack of suitable financial assets – in that sense the funds are too big.





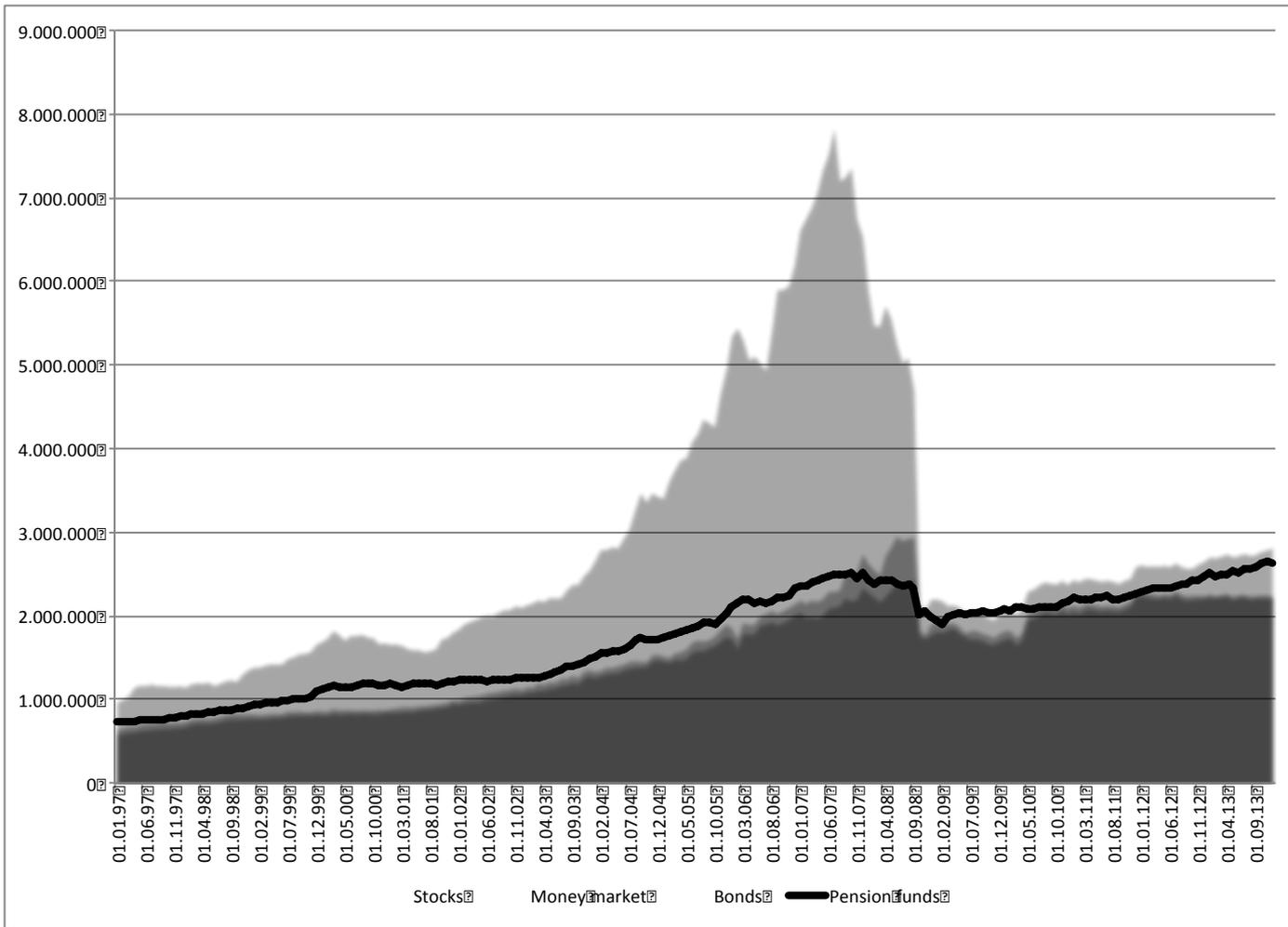
# Some aspects of the current problem

- The stock market post crash is still quite small, market cap limited and few listed firms.
- Capital controls prevent additional foreign investments.
- Small and even decreasing supply of listed bonds.
- Bond yields at a historic low (for Iceland)
- Pension funds own a very large proportion of several asset classes, undermining the market pricing mechanism.
- Serious anti-trust concerns when competing firms have the same owners.
- Governance issues: Pension funds ill-suited as leading investors in corporate shares.
- Risk of asset price bubble.





# Big fish in a little pond: Listed assets



Millions of ISK at Jan. 2014 prices. Listed stocks and bonds and total pension system assets.





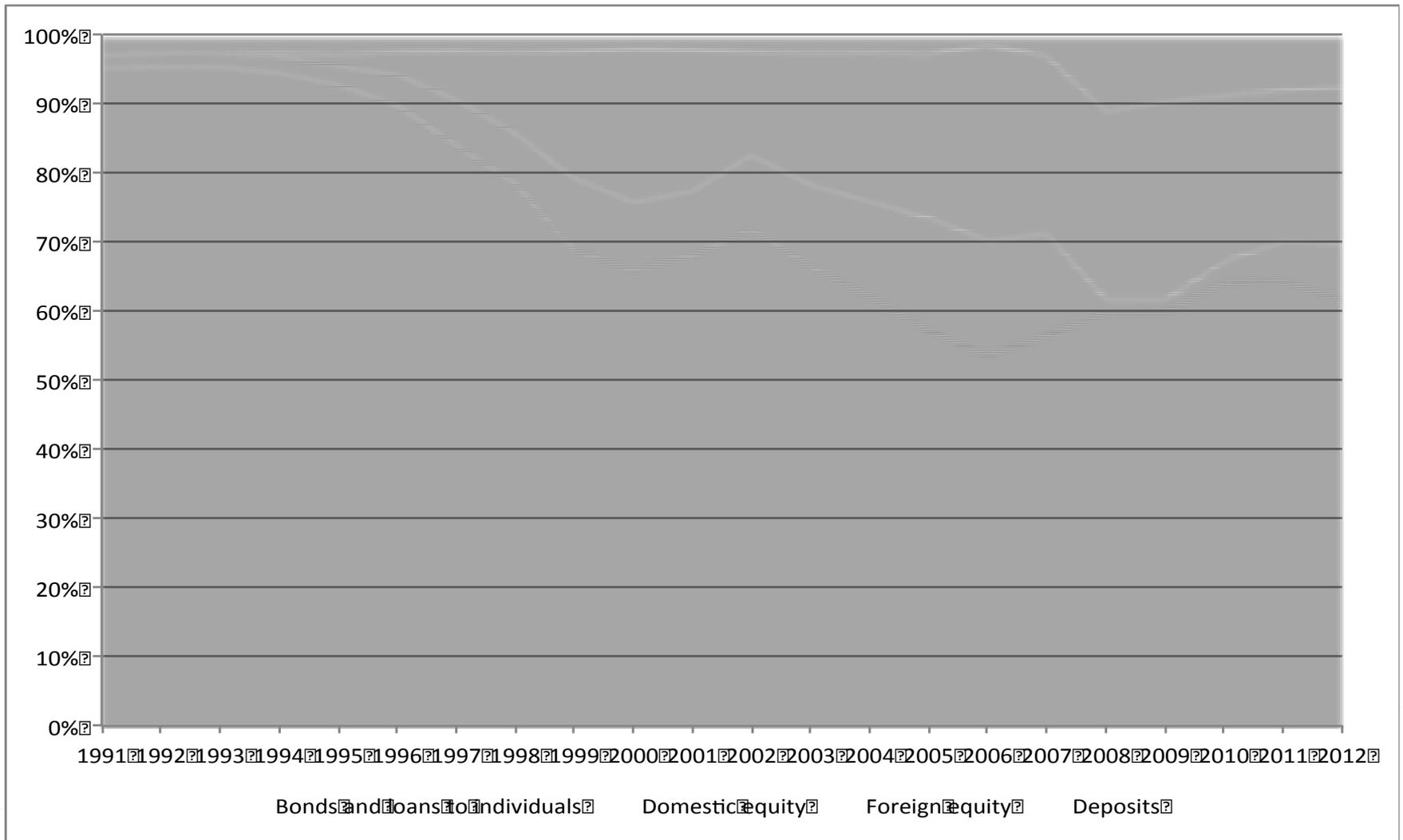
# Listed assets (Nasdaq OMX Iceland)

| <i>Position in ISK mill.</i>        | <b>31.12.13</b> | <b>12 month growth<br/>rate (real)</b> |
|-------------------------------------|-----------------|--|
| <b>Bonds &amp; notes</b>            | 2.253.279       | 0,2%                                   |
| Nominal Treasury bonds              | 640.507         | -3,8%                                  |
| Inflation-linked Treasury bonds     | 190.779         | 5,6%                                   |
| Bank bonds                          | 184.145         | 19,4%                                  |
| HFF bonds                           | 783.419         | -5,0%                                  |
| Housing authority bonds             | 21.741          | -6,7%                                  |
| Housing bonds                       | 29.319          | -20,5%                                 |
| Other credit institutions' bonds    | 57.817          | 13,5%                                  |
| Listed corporate bonds              | 165.808         | 20,3%                                  |
| Listed bonds of municipalities      | 62.445          | 3,9%                                   |
| Listed foreign bonds                | 117.300         | 2,7%                                   |
| <br><b>Money market instruments</b> | <br>31.399      | <br>-20,8%                             |
| <br><b>Listed equities</b>          | <br>582.848     | <br>40,5%                              |
| ICEX Main list                      | 536.252         | 40,8%                                  |
| Other / First North                 | 46.596          | 36,6%                                  |



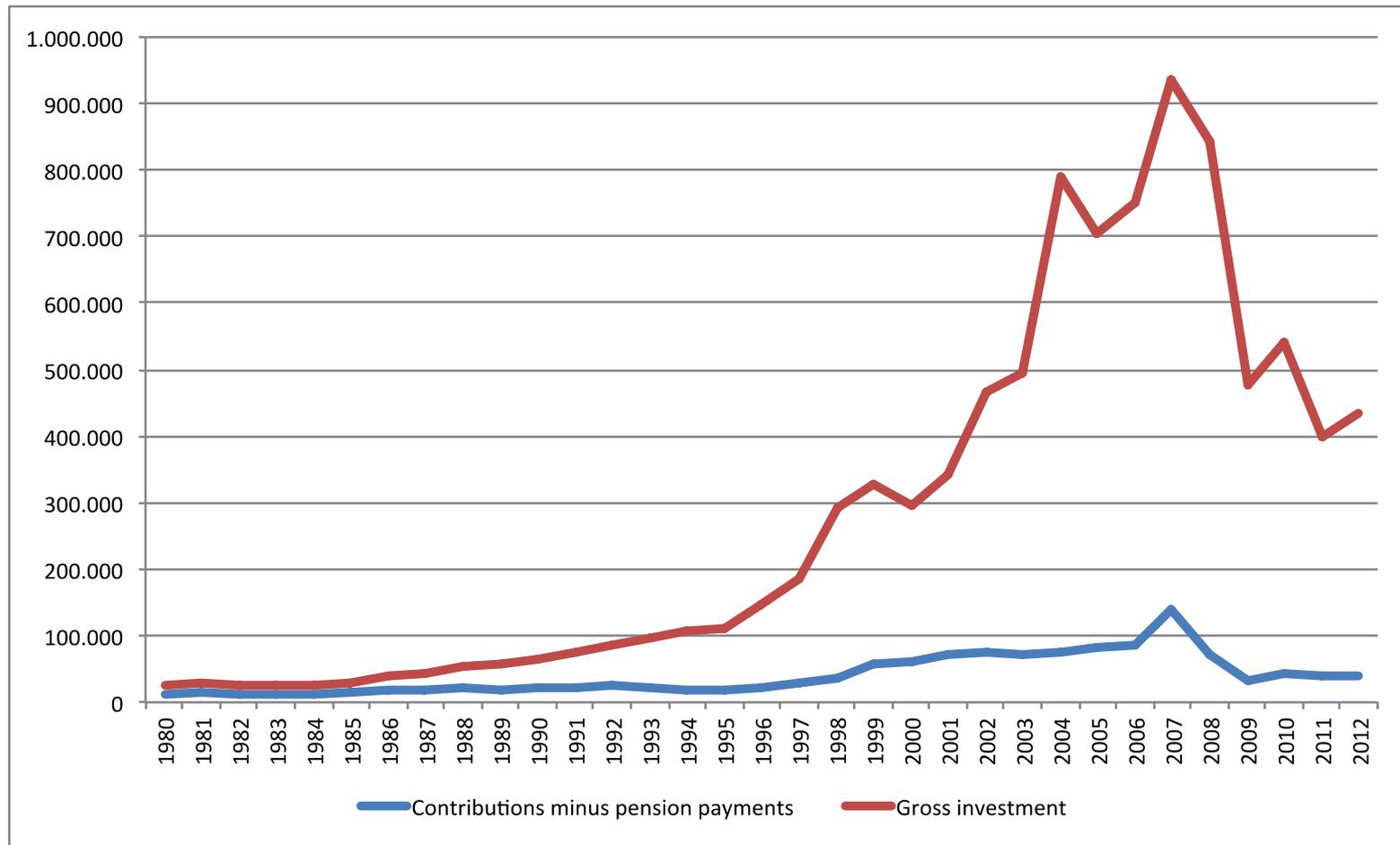


# Division of pension fund assets (approx.)





# Substantial investment need



Millions of ISK at Jan. 2014 prices.





# Shortage of financial assets

- Listed assets 2.900 billion ISK at year-end 2013.
- Net worth of pension system 2.650 billion ISK (of that foreign assets 600 billion) year-end 2013.
- Projections are for further growth of pension funds until their size will peak due to changing demographics.
- This will not work unless:
  - a) The stock of domestic investment grade financial assets grows.
  - b) The funds are again allowed to invest abroad.





# Real assets

- **Iceland's real assets** approximately 6.800 billion ISK (excluding human capital and natural resources).
- **Value of economy** in excess of 50.000 billion ISK (future capacity to generate consumption goods in present value).
- Impossible to generate financial assets corresponding to **all** of this but probably a higher proportion than now.





# Growth of listed assets

- Market cap of listed shares now 580 billion ISK or 32% of GDP.
- Not unreasonable to expect this to grow to 60-90% of GDP (6-900 billion ISK increase) but that will take time.
- Harder to predict the growth of the bond market, in part due to the current trend towards deleveraging of all sectors (household, corporate, government)





# What options are there?

- The law on pension funds can be amended, allowing for more investments in some asset classes.
- This will however not change the overall picture dramatically.
- Allow the pension funds to invest abroad
- This calls for increased inbound foreign investment or borrowing or a slower repayment of existing foreign debt by Icelandic entities as the current account surplus is limited.
- “Large investments”: Banks, power companies.

