

# Finland Temporary rules extend helping hand to long-term plans

An extension of temporary solvency and investment rules has helped pension funds to hold on to their long-term strategies, finds Reeta Paakkinen

In Finland, temporary solvency and investment regulations allowing higher risk exposure by first pillar pension funds have been continued by another two years. The temporary rules were introduced for a two-year period in December 2008 as a response to the global finance crisis. Their purpose was to reinforce the actuarial solvency position of pension funds and to allow them to keep more risk in their portfolios. During market turbulence, this would prevent large-scale sales of equity holdings, which could have hurt the Finnish real economy and listed companies.

The Finnish government proposed to continue the temporary rule in February, and the proposal was approved by parliament in late March. The temporary regulations will be in force until 2012, when a more concrete set of new regulations, currently being planned by two working groups, is expected to come into force.

One of the working groups is assessing, from a broader perspective, the changes that have taken place in investment markets and their impact on pension regulations. It is also considering what reforms are needed for the existing solvency and investment regulations. The group is led by Antero Kiviniemi, director at the insurance department of ministry of social affairs and health.

The other working group is led by Lauri Koivusalo, former managing director of Etera Mutual Insurance Company. It is looking at the impact of the temporary regulation and the potential effects of its discontinuation and will make proposals from the broader perspective of the pension system. The two groups are expected to submit their reform proposals to Liisa Hyssälä, the minister of social affairs and health, by the end of April.

Kiviniemi says that going back to the pre-crisis solvency rules would have reduced pension funds' ability to retain investments which carry more risk but offer higher return potential. "If equity markets were again to start performing poorly, pension funds would most likely have to reduce their portfolio risk before the temporary rule ends this year. In practice, this would mean the sale of domestic equities, which could hurt local economy in a much wider sense," Kiviniemi says.

The extension of the temporary rule is also to allow time for the pensions industry to prepare for the permanent changes in the solvency and investment regulations that the two working groups are drafting. "The extension of the temporary rule gives the industry time to prepare for further changes, which are likely to be adopted in legislation around 2012," Kiviniemi explains.

He says the current regulations on solvency and risk limits need updating. "For example, risk calculations and correlations for certain asset

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classes, like hedge funds and equities, should be updated to reflect more the current market environment and their actual risk level."

Matti Leppälä, director of international and legal affairs at the Finnish Pensions Alliance (TELA) agrees with this view. "The existing risk parameters and regulations were drafted in 2003 and they came into force in 2007. A lot in investment markets has changed since, especially with the recent market turbulence. On the other hand, the finance crisis was an exceptional event, which does not reflect normal market conditions," Leppälä says.

The current regulations divide asset classes into five main groups and 20 subgroups, according to risk level. "The regulation stipulates that correlations of the sub-categories within the main groups correlate perfectly. But, of course, in practice this is not the case, for example, if we compare hedge funds and equities. There is need to update the parameters and make them more sophisticated," Leppälä says.

The local pensions industry strongly supported the continuation of the temporary arrangement as it enables them to plan their investment strategy for 2011 well in advance. Timo Ritakallio, deputy chief executive officer

and head of investments at the €26bn Ilmarinen, says that the continuation of the temporary rule benefits the sector as a whole. "We recovered from the earlier losses so well over 2009, that, for us, the continuation was not necessary. But for the industry as a whole it is a positive thing, which helps to balance the situation further. There will be no need to speculate about the future," Ritakallio says.

In 2009, Ilmarinen's investments generated 15.8% – the best total return of all mutual pension insurance companies in Finland, a radical improvement since the -17.7% return of 2008.

"The temporary rule enabled us to keep our equity holdings at a steady level and even increase our equity exposure," Ritakallio says. "Despite falls in the equity markets we did not need to start selling our holdings. Without the temporary rule, our returns would have been far from the best in our history."

At Ilmarinen, the best performing asset class was equities, which made up 35% of the total portfolio and yielded 34.8%. This was a major improvement on the -42.2% figure in 2008. Domestic equities accounted for 40.9% of the equity portfolio.

Ritakallio says Ilmarinen's equity exposure is likely to stay at its current level through 2010. "We may reduce our equity exposure slightly, perhaps to 30%, and are planning to orientate both our equity and bond holdings slightly more towards emerging markets. This plan will proceed gradually. As we have seen in the past two years, too-rapid moves have created bubbles and overheating also in emerging markets."

Ilmarinen is also planning to increase its property holdings from the current 10% to 15% in the next five years. "Private equity is another asset class that we plan to gradually invest in more," Ritakallio says.

He says that more attention should be paid to liquidity risk in the future. "The crisis has shown this to be much more important than earlier thought."

Staffan Sevón, chief investment officer at the €1.9bn Veritas Pension Insurance notes that although Veritas' solvency was not at risk even during the most turbulent of times, the continuation of the temporary legislation allowed the firm and the whole pensions industry to maintain a long-term approach to asset allocation. "Without it there would have been an uncomfortable degree of risk, which may have left some of the less solvent companies no other alternative than to reduce their risk to a level where – taking into account the low interest rates – a sufficient expected return to cover the growth in liabilities would not have been possible," Sevón explains.

At the end of 2009, Veritas's solvency level was 21.3% over the minimum. It estimates that without the temporary rule, its solvency would have been at 16.4% over the minimum at the end of the year. Veritas investments yielded a return of 10.8%, a notable improvement since the -15.5% return in 2008. Listed equities drew in the best returns at 45.3%.

This year, Veritas plans to re-build its matured private equity portfolio and to further diversify its listed equities portfolio. "Private equity seems to offer reasonable valuations combined with less market risk than listed equities. I am not necessarily a proponent of the view that private equity

## Nordic ESG: preparation for the next generation

SARAH DUDNEY

"Is it just a fashionable term? How do you define it?" responded one senior Danish CIO when asked about environment, social and governance matters. "No matter what the fashion, the financials have to come together." This is a commonly voiced point of view on this topic in the Nordic region, and the voices in favour of change are mostly those of governments and regulators.

In recent months, governments have worked with public pension funds using regulation to push ESG forward on the investment agenda. Danish investors have certainly advanced best practice in Europe, accompanied by their Swedish counterparts, who were early adopters in this area. In 2009, the Danish government dedicated funding via UNPRI to create an academic network that explores investment issues of ESG, including integration and engagement. This May this network holds its first conference and award ceremony in Copenhagen to commend the best research paper.

At the time of writing there were 44 Danish asset owner signatories

of the UNPRI from a global total of 723 asset owners, investment companies, and consultants. Denmark is also introducing a law this year to stipulate that public pension funds will have to incorporate SRI into their annual accounts. Membership of UNPRI fulfils that legal requirement and membership is not simply a signed form that is filed and quickly forgotten. After a year's membership, a random sample of members is taken and UNPRI runs an extensive survey (98 questions in total) of selected participants. Those that do not meet standards set around the principles can be delisted.

Integration and engagement is not always straightforward, however. If governance around certain failed financial institutions during the credit crisis was questionable, surely better governance structures should be at the top of the agenda. This should be the case with Iceland but economic and financial survival is a top national priority.

Regulation is also costly and Nordic pension funds, like those in other parts of Europe, are dealing with onerous new regulations coming from all directions. Implement-

ing Solvency II is a significant undertaking, as is dealing with accountancy rules, refining risk management and investment policy.

It is obvious to repeat that Danish and Swedish pension funds represent a sizeable multi-billion investment segment which is appealing to investment firms. How can they monetise the challenge that ESG presents? Where does ESG sit within client portfolios in terms of risk and return? A survey of European CIOs for this article reveals that they would like ESG-related investment products to:

- Meet appropriate risk/return criteria;
- Present a positive incentive to engage in investment rather than screening out negatives. Negative screening is seen by some as passive engagement and complex to run;
- Be straightforward conceptually and easy to explain to a non expert audience;
- Be flexible and able to be customised – what we think today on climate change and implement through an investment policy might be different in 18 months' time;
- Be cost effective in implementation.

So CIOs who want to examine ESG are not only managing uncertainty in the investment world but also within the scientific world too.

One new innovation in the market comes from Osmosis Investments in London which, in partnership with HSBC, launched the first Climate Solutions index in February. This is a compilation of 100 globally listed companies which derive more than 50% of their revenues from products or services focused on the efficient use of natural resources and the mitigation of climate change. The ETF vehicle offers liquidity and transparency which addresses key concerns within the institutional sector. Denise Saber, recently hired from Insight Investments, now heads distribution at Osmosis and says Northern Europe is a prime target.

Recent momentum for this generation of ESG investment has been driven by the letter of the law. As ever, regulatory change presents both a commercial and intellectual challenge both for pension funds and investment houses that can crack the scientific and investment debates.

outperforms listed equities given similar levels of leverage. On the other hand, I can see very little benefit from being held hostage to market volatility caused by the morning mood of 25-year-old prop-traders," Sevón says. "On the listed equity side, we have resourced seeking and monitoring external funds and are evaluating a few options for consultancy partnerships in that area."

Kari Vatanen, chief risk officer at €29.9bn Varma Mutual Pension Insurance, on the other hand, believes the current investment regulations do not need major changes. "However, small adjustments in the regulations on risk management are in place. Solvency II gives good tools for this," Vatanen says.

For example, some of the regulations on asset classes are illogical and outdated, Vatanen notes. "There are strict limits on emerging market investments, although that is exactly where economic growth is expected to kick off.

Furthermore, some investments, which were earlier seen as somewhat exotic due to their currency risk – like US or Swedish bonds – are really not that exotic any more," he explains.

During the market turbulence, Varma hedged its equity exposure by using derivatives. The temporary legislation enabled it to keep its Finnish-listed stocks

while reducing other types of equity risk in the portfolio.

"There were times our relative exposure to Finnish equities in the equity portfolio was very high. We protected our portfolio through derivatives and for a while dropped our total equity exposure to 4.4%," Vatanen says. "If large pension investors started selling out their domestic equities because of their risk levels in the beginning of 2009, this would have had serious consequences for the Finnish economy."

At the end of 2009, Varma's equity exposure had again reached a more conventional level of 23%. Bonds made up 44% of the portfolio, property 15%, hedge funds 11%, private equity 5% and commodities 2%. The portfolio generated a return of 14.1% in 2009, the best in Varma's history. The performance was driven by equities, which yielded

46.4%. Varma is unlikely to make radical changes to its asset allocation over 2010. "The crisis taught us a lot about being careful and acting prudently. Actions taken to manage risk can be quite big moves. Liquidity is also playing a much more important role in risk management than ever before," Vatanen concludes.

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Staffan Sevón

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