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CONTRIBUTION OF PENSION FUNDS AND DEVELOPMENT BANKS TO CAPITAL MARKETS IN BRAZIL

This article is based on a plenary presentation made at the 3rd annual World Pensions Council (WPC) conference, held in Hong Kong on November 7-8 2013.

Long-term investment drivers can be classified into four different models, depending on the source of the funding. These models include Credit (for example: Germany, France), Capital Markets (USA, UK), Government Driven (Italy, Brazil, China) or Corporations (Japan, South Korea).

In Brazil, several institutions were and are important in funding investments. This article focuses on the role of BNDES[1] and pension funds as motors of long-term growth. BNDES, the Brazilian Development Bank, founded in 1952, has been the sole provider of long-term credit during most of the last 60 years. In addition, BNDES' equity subsidiary BNDESPar, which is similar to the World Bank's IFC[2], supported governance-oriented investment funds as of the late 1990's and in the 2000's private equity funds.

The great majority of pension funds were created in the mid-seventies. Assets experienced huge growth from 1985 until 2007, soaring from 1.6% to 17.2% of GDP. Afterwards low market returns and low GDP growth kept this figure stable. At the end of 2012, pension funds' assets accounted for 15.2% of Brazilian GDP. Before 1995, Brazil´s high inflation induced fixed income investments to very low duration and inflation's huge volatility compelled investors to demand very high returns in order to ensure real returns to cover liabilities. Due to regulation, pension funds´s liabilities were discounted at a maximum of 6% per annum. As interest rates were very high, the asset allocation was and still is strongly concentrated on the fixed income asset class. The privatization program set off by the government in 1991 resulted in the larger pension funds joining and adopting corporate governance standards much in the way USA pension funds did at the same time. These aspects and the taming of inflation set the ground for pension funds modus operandi up to the present day.

PENSIONS PLAYING KEY ROLE ACROSS DOMESTIC ASSET CLASSES

In Brazil, there are 327 pension funds comprising 1,088 pension plans sponsored by 2,803 companies. Pension assets total US$ 332.1 billion[3] with the following distribution: Fixed Income at 61.7%; Equity at 28.6%; Real Estate at 4%; Other Alternatives at 2.7%; Loans to Participants at 2.6% and Cash at 0.4% [4] . The aggregate figures are distorted by the differentiated asset allocation practiced by less than 20 of the very large pension funds in relation to the other 300. The median allocation in equity is little more than 10% and in alternatives, real estate and loans to participants altogether less than 6%, with the remainder 85% invested in fixed income. Due to their long-term liabilities linked to inflation and a majority of in-house managed assets, large pension funds are important players in capital markets. Financial products are usually shaped to their profile.

Amid the major asset classes, the following comments are noteworthy.

In fixed income, the appetite for longer duration securities and the "buy and hold until maturity" tactic allowed public and private issuers to stretch out maturities and duration. Pension funds were the forerunners in buying long-term private debt, now responsible for 37% of fixed income allocation. A typical attribute of Brazilian portfolios is the demand for inflation linked bonds, due to the inflation history in the country. In recent years also ABS funds and REIT funds are increasing their share in portfolios.

In the equity asset class, pension funds hold 17% of market capitalization float. They prefer to invest actively in portfolios either benchmarked against broad indexes or focused on total return and concentrated small cap strategies. ETFs are gaining momentum as well. Pension funds are also increasing their share in private equity. They have committed 13.3% of total US$ 40.7 billion[5] invested in the country at the end of 2012, compared to 7.7% in the previous year. A few large pension funds are aggressively increasing their stake in this segment with noticeably strong corporate governance.

BNDES AT THE HEART OF THE NATION'S ECONOMIC ECOSYSTEM

Another government agency called Finep, the Brazilian Innovation Agency, also plays an important role fostering private equity, venture capital and seed capital funds. In the last 13 years, 280 funds were analyzed, of which 27 were approved. US$ 325 million were invested in 100 companies leveraging a total investment of US$ 2,150 million.

The Brazilian Development Bank - BNDES is a powerhouse in the Brazilian scenario with assets of US$ 350 billion and a yearly disbursement budget of US$ 76 billion. Its portfolio in capital markets includes US$ 39 billion in shares of 130 companies, 60 of which are highly traded and US$ 8.1 billion in bonds. In addition it has committed US$ 1 billion out of US$ 4.2 billion in 32 Private Equity Funds that invested in 207 companies. In qualitative terms, BNDES is an active shareholder. Thus, it enforces governance, appoints members of the board, demands tag-along and drag-along rights for minority shareholders and requires invested companies to list its shares. The operational criteria and policies followed in loans and equity funding lower capital cost, increase shareholder returns and improve minority shareholders rights. These positively impact free cash flow, capital structure, competitiveness, size and result in higher multiples when compared to its peers. In the last few years, a new role emerged with BNDES' supporting also bond primary and secondary markets.

Recently government bonds interest rates reached an unprecedented historic low level for Brazil. These yields resulted in regulator measures lowering discount rates applicable to liabilities and consequently higher liabilities for pension funds. Solutions to cope with this new situation include increasing contributions, reducing benefits or rising returns and risks from investments. Considering how unpopular the first two alternatives are, the likely path should be re-assessing the fixed income paradigm changing asset allocation and increasing risk exposure. Assets targeted to do so include private bonds, equity, real estate, alternatives and international investments.

At the same time, pension coverage in Brazil is not high. Sources of demand growth include pension financial products, existing and new civil servants pension plans. Established in 1997, financial pension products managed by banks, asset managers and insurance companies have assets of US$ 150 billion. The 7.5 million civil existing servants are covered by retirement plan on a pay-as-you-go basis. Its assets total US$ 90 billion. All new civil servants at federal, state and town level will be entitled to pension plans on a contribution basis.

The majority of Brazilian pension funds were established in the mid-seventies. Pension assets experienced remarkable growth from 1985 until 2007, soaring from 1.6% to 17.2% of GDP. Afterwards low market returns and low GDP growth kept this figure stable. At the end of 2012, pension funds' assets accounted for 15.2% of Brazilian GDP.

Of the four models mentioned in the beginning of this article, government credit has been the major source of long term growth funding in Brazil. BNDES´ yearly flow is much higher than the inflow of IPOs in the stock exchanges, new issues in the bond market or the flow from pension plans. The stock of shares in the capital markets represent around 50% of GDP but only less than 400 companies are listed. The total market value of bonds is around only 12% of GDP. Planned investments in industry and infrastructure from 2013 to 2017 are estimated around US$1,700 billion[7], except housing. Since government credit has little room to grow, companies are not leveraged and not listed, and the pension flow could increase significantly, capital markets might have the chance to play the leading role in funding long-term growth in Brazil.■

(1) Banco Nacional de Desenvolvimento Economicaoe Social, Brazil's national development bank was founded in 1952.

(2) International Finance Corporation Participaçoes SA.

(3) Figures refer to the end of 2012.

(4) Source: Abrapp –Brazilian Pension Fund Association.

(5) Source: ABVCap – Brazilian Venture Capital and Private Equity Association.

(6) Carvalhal & Zorman, 2013.

(7) Source: BNDES.