How We Run Our Money

Iceland's Frjalsi is starting to feel the effects of economic recovery but capital controls weigh heavily over its investment policy. **Nina Röhrbein** spoke with **Arnaldur Loftsson** (pictured right) and **Marinó Tryggvason** (left)

Northern lights

Illustration: Michael McGuiness

It is probably fair to say that no other country and its pension funds experienced a rollercoaster ride in recent years quite like Iceland.

The 2008 banking crisis brought with it a darkness similar to the one that engulfs the country's long winter days, and led to the collapse of the domestic equity, corporate and financial credit markets.

But far on the horizon, like a glimmer of the northern lights, things are beginning to brighten.

However, while the economy may be showing some signs of improvement, Icelandic pension funds still feel trapped by the capital controls placed upon them by the Central Bank in the autumn of 2008.

One of the pension funds coping with the Arctic conditions is Frjálsi Lífeyrissjóðurinn. Founded in 1978, it is the oldest independent pension fund in Iceland, and, following mergers with four other pension funds, has grown substantially over the last decade.

It is open to all wage earners who are not contractually obliged to be members of other pension funds. Most of its 42,000 members are self-employed or in supervisory positions at various organisations. But it can also receive supplementary pension savings from members of collective agreement schemes into its third-pillar, private pension fund.

It is this supplementary part that gives Frjálsi its special structure. In Iceland most pension schemes are co-insurance funds where all premiums or contributions go into a non-inheritable co-insurance fund. But Frjálsi is a hybrid of private and co-insurance fund. While the co-insurance second-pillar part guarantees its members the minimum pension set by law, some of the premiums or contributions are also paid into a private fund. This private pension is fully inheritable and designed to enable members to take early retirement ahead of their state retirement age of 67 – from age 60 – or to boost their income during their early years of retirement.

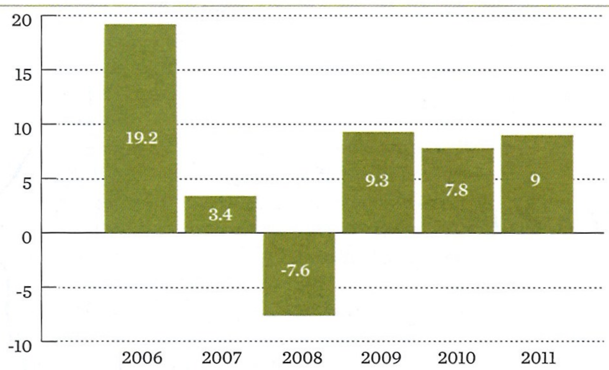
"At most Icelandic pension funds, the mandatory premium fully goes into the co-insurance but at Frjálsi we emphasise the private pension part to maximise contributions," says Arnaldur Loftsson, managing director at Frjálsi.

The mandatory contribution into the co-insurance fund is 12% of a member's salary, 8% of which is paid by the employer in line with union contracts. Wage earners can pay an additional tax-deductible 2% into the supplementary pension, which is typically matched by the employer.

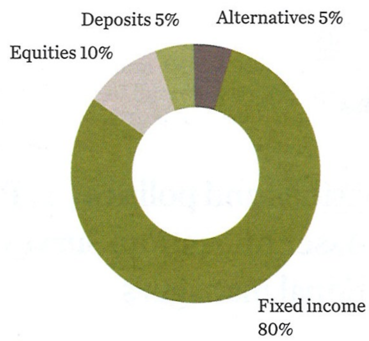
The mandatory, co-insurance part of the pension fund is invested 88% in fixed income,

Investment strategy of Frjálsi Pension Fund

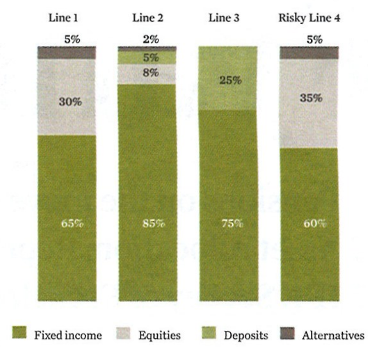
Nominal investment returns for Frjálsi (%) – mandatory part



Mandatory pension asset allocation (%)



Supplementary pension asset allocation (%)



7% equities and 5% alternatives. Members can choose between three co-insurance options.

In the private pension part, Frjálsi members can select from four investment lines with various risk levels. These range from the safest investment line with a 100% allocation to bonds and deposits to the riskiest with 60% fixed income, 35% equities and 5% alternatives.

For the undecided, it offers a lifepath approach, excluding the riskiest line, whereby the pension fund moves members into different funds according to their age.

The majority of members – around 60% – invest in investment line one, which comprises 65% bonds, 30% equities, and 5% alternatives.

Overall, Frjálsi's asset allocation has remained relatively stable in recent years, largely because of the capital controls which rendered any big moves impossible.

"The capital controls do not allow the purchase of new foreign assets, in other words, if we sell any of our foreign assets and convert them to Icelandic króna we cannot convert the capital again to buy new foreign assets," says Marinó Tryggvason, in charge of asset management at Frjálsi. "This is why our strategic asset allocation has not changed much since the banking crisis of 2008. However, the collapse of the Icelandic stock market in the same year cut our Icelandic equity holdings from 10% to almost zero. Last year, we increased our exposure to Icelandic listed equities again to 2%."

"There is much more activity in the unlisted equity space, which is where we have an allocation of 3-4%," adds Loftsson.

In 2010 and 2011, the pension fund invested in a domestic private equity fund which focuses on soon-to-be listed companies, including Iceland's largest domestic retail and insurance companies. In partnership with other pension funds, it also directly invested in the largest domestic power company.

Of the overall listed equity exposure, 25% is allocated to non-domestic equities.

In the fixed income area, the pension fund mainly invests in Icelandic index-linked government bonds. In addition, it has a small allocation to foreign short-term bonds.

Frjálsi Pension Fund at a glance

- **Fund type:**
  Multi-employer professional pension fund
  Hybrid mandatory and supplementary scheme
- **Fund structure:**
  Open hybrid DB/DC
- **Members:**

Overall	42,000
Active	15,518
Retired	1,812

- **Date established:** 1978
- **Assets:** ISK100bn (€600m)

"Again this is largely due to the capital controls," says Tryggvason. If we do not want to sell foreign assets and transfer them into Icelandic króna, we keep them in short maturity bonds. These are not yielding anything – for us, they are just like safety bonds."

Frjálsi also invests a small amount in asset-backed securities, both for corporates and financials. It buys bonds of companies with strong cashflows and balance sheets where the collateral is deemed to be secure, in most cases fully or semi-government owned.

Alternatives now consist 90% private equity. Prior to the country's banking crisis, the allocation to alternatives was evenly split between hedge funds and private equity.

"Capital controls are the cornerstone of our strategy," says Loftsson. "They are also likely to lead to an asset bubble because the supply of investable capital is much higher than the supply of assets investors like ourselves can buy. Faced with this situation, we have been trying to buy as many long-term real income streams as possible, including long-term index-linked bonds and real estate. If the capital controls remain in place for a long time, longer-term real income streams will become more valuable."

The situation is not made easier by the fact that second pillar pension funds in Iceland have to produce a return of 3.5% plus inflation every year. Frjálsi feels that pressure too although its co-insurance part only makes up 20% of the total fund.

"We have managed to achieve this target over the last few years but it is challenging to say the least," says Tryggvason. "The yield on index-linked government bonds is at around 2.8% at present, which makes it difficult to generate 3.5% after costs."

The return on the co-insurance part of the fund was 3.6% plus inflation in 2011, and 5% in 2010.

The impact of the new guidelines on risk management issued by the Icelandic financial services authority (FME), which have to be implemented by year-end, is limited, as Frjálsi has invested heavily in in-house risk management systems following the crisis. This means that the pension fund is already 70-80% compliant with the new rules.

For every new investment, customised due diligence is carried out, mainly focusing on investor governance, investment democracy, exit points, involvement in the investment committee, transparency, fair incentives in fee structures and regular information.

The pension fund has felt some signs of recovery. The number of active members paying their contributions, for example, grew by around 8% between 2010 and 2011, while the average contribution rate also rose to 16%, due to rising wages, more people finding jobs as well as more people switching pension funds.

But Loftsson expects contributions to decline in the short term after the eligible tax-deductible amount to be paid into the supplementary pension fund was halved to 2% in January in order to boost tax payments and consumer spending. This measure is set to be in place for three years before the tax-deductible amount increases again to 4%.

But the main challenges for Frjálsi remain finding investments that can generate 3.5% plus inflation for the co-insurance part, and safeguarding the portfolio against inflation.

"We are afraid that inflation will follow the asset bubble," says Loftsson.

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> Arnaldur Loftsson