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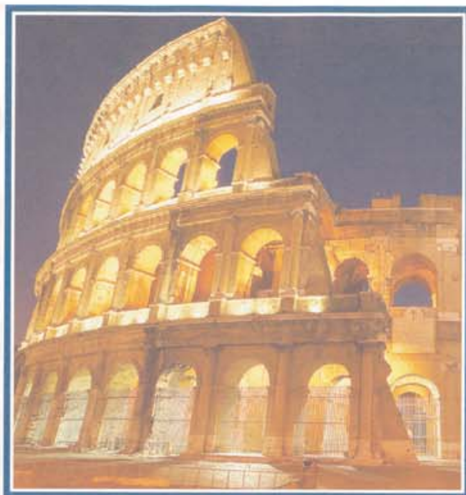

Evolution of Italy's occupational system

It's a period of change for Italian pensions. Hopes are high that last year's new pension legislation will stimulate a strong flow of new money into pension funds, says **Rachel Alembakis**

THE ITALIAN occupational system is dominated by speculation over the effects of the 2004 pension reform package promulgated by Silvio Berlusconi's government, which is designed to spur significant new inflows of assets to pension funds. But even as industry insiders estimate the impact of the reforms, the day to day evolution of the relatively young occupational pension system continues. Pension funds are gradually leaving the balanced portfolio behind, offering their employees more choice and stepping into larger single-asset mandates.

Meanwhile, pension funds are also benefiting from a management fee environment that is significantly cheaper than other European companies, with large industry-wide funds often paying managers less than 20bp. This situation is expected to continue for at least a few more years because of an abundance of fund managers competing for pension fund business, plus the willingness of the large industry-wide pension funds to use their size as a bargaining chip. Fondenergia, the €320m industry-wide pension for the oil and energy sector, currently pays around 8bp plus a performance bonus of 15% for investment management. A good overperformance could bring the total to 20bp in total.

"In my opinion, the market must change and allow higher fees for managers," said Alessandro Stori, manager of Fondenergia. "But when we renew our RFPs, we see new people willing to join the market and that keeps [fee] levels down. Everyone wants in on the Italian pension fund market, so I think that commissions will stay low for some years to come."

Paolo Moia, general manager of Sanpaolo IMI Institutional Asset Management, attributed the relatively low level of manager fees to the fact that, until now, pension fund choices have been fairly garden-variety – by the book balanced mandates.

"You receive a mandate for money markets, bonds and large cap equities," he noted. "The costs associated with those investments are quite low. As long as we don't see exotic asset classes, there will be no increases in management fees."

Moia, however, does predict that pension funds will gradually gravitate towards single asset class and alternative investments, but only in small amounts, which will only marginally raise the overall management fees paid by pension funds.

Currently, fund managers are awaiting the effect of the 2004 pension reforms – an interest that has historical parallels, noted Piero Marchettini, managing partner of Adelaide Consulting.

"This is not the first time that foreign players believed that the Italian market will develop," Marchettini said. "The fund managers that started business at the end of the 1980s were attracted by the idea of an institutional pension market, but basically it was a failure. They were relatively lucky because the mutual fund market developed, and they have more than paid for themselves that way. The ones coming in now also feel there is a market with pension funds, but they will not be lucky because there will not be a second wave of mutual fund development."

Industry-wide funds dominate

Industry-wide pension funds dominate as much as 90% of the occupational pension market, and amounted to some €5.6bn by the end of 2004, according to figures from the Commissione di Vigilanza sui Fondi Pensione (COVIP), the Italian pensions regulator. It is worth noting that three of the largest industry-wide pension funds alone make up more than half of that amount – Cometa, the pension fund for mechanical and engineering employees has assets under management worth €2bn, Fonchim, the industry-wide pension scheme for chemical and pharmaceutical workers has €1bn in assets under management, and Fondenergia, the industry-wide pension for the oil and energy sector has €320m in assets. Most of the industry-wide funds were founded in and after 1997.

Initially, these pension funds offered members only one fund choice – the so-called *monocomparto*, usually a balanced fund heavily tilted towards bonds. Recently, however, as fund assets and investment sophistication have grown, funds have begun offering more choices, or *multicomparto*.

"What we are seeing is that they are moving, or they have moved to *multicomparto*, particularly in the past six months," said Sergio Trezzi, head of business development for the southern European region at INVESCO in Milan. "In moving to *multicomparto*, some of them have moved their investment needs from asking for balanced products to single asset class products. This is not what all these funds have done, but you can see a trend towards this, which is normal, because in moving from *monocomparto* to *multicomparto*, and having different profiles of risk/return and having bigger assets under management, funds can look for single asset investments."

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Sergio Trezzi, INVESCO

'Small or new funds have a lack of resources and membership. They've no ability to go to specialist mandates if they have between €20m and €100m of AUM'

Andrea Canavesio, MangustaRisk

Despite the decisions of large funds like Fonchim and Fondenergia to increase their investment fund choices for members, the overwhelming majority of pension fund members stay with the balanced choice, which generally has between two thirds and three quarters invested in bonds and one quarter to one third invested in equities. At Fonchim, 92% of members have stayed with the so-called "stability" choice, with 5% in a more conservative fund, and 3% in the dynamic option, said Andrea Girardelli, Fonchim's director. Similarly at Fondenergia, 92% of members are in the balanced fund, 6% are in the conservative fund, and 2% are in the dynamic fund, Stori confirmed.

This trend is broadly true across the industry, Trezzi at INVESCO said: "It is true to say that in the pension funds, our clients are still more in favour of protected products and money market options, and are still approaching the equity side very slowly. When you look at *multicomparto* funds, you still see much of the assets are in more secure options – money markets and balanced with low percentages of equity."

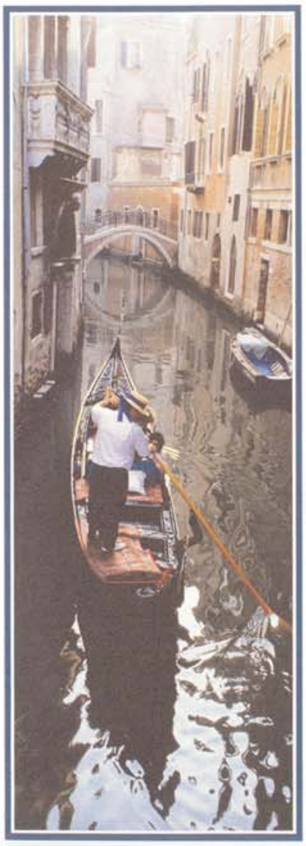
One barrier to seeing greater member migration to more dynamic, higher risk/reward options is the fact that members cannot be invested in more than one option at one time, said Arrigo Beltrame, a consultant with Watson Wyatt.

"Pension funds are moving from balanced to multiple options and you do have funds with two to four options," he said. "But what you can't do is mix options. As of now, you have to choose one."

Despite the relative lack of demand for more aggressive investment choices, pension funds are pressing ahead with new choices. Many of the new pension funds are just going through, or will in the next few years embark on their first ALM studies since making initial investments. There is an increased desire, at least in the largest pension funds, to make more sophisticated asset allocations, to venture into single-asset classes and to consider alternative investments such as private equity and real estate.

"In terms of products, we are trying to develop new asset classes," said Moia of Sanpaolo IMI. "For example, we are pushing inflation linked security portfolios, and we are doing a lot of education on that. We are also trying to push the investment in terms of equity investment, and we tend to develop single asset class portfolios. I think that this is also a development of the whole market."

This evolution is attributed to the larger



pension funds – the newer, small and medium sized pension funds, by virtue of their smaller size, tend to stick with the balanced option, noted Andrea Canavesio, a partner with consultants, MangustaRisk in Rome.

"The small or the new pension funds have a lack of resources and a lack of membership," he said. "They have no ability to go to specialist mandates if they have between €20m and €100m of assets under management."

This could change, however, if pension funds receive a large inflow of assets as a result of the reform package of 2004.

Berlusconi reforms: effect unquantified

The reform package passed last year is both a symptom of and a proposed solution to strengthen the small and relatively weak Italian occupational pension system. The most important component of the package is that it will transfer to occupational pension funds the *Trattamento di Fine Rapporto* (Tfr), a statutory payment made by firms when employees leave, either in retirement, termination or voluntary departure. The Tfr – nearly 7% of an employee's annual salary into the Tfr, 40% of which is the employer's contribution – is held as a company book reserve. The Tfr payments are in addition to the 33% employee contribution to the state pension system, and whatever additional supplemental pension fund arrangements the employer may have.

Although the legislation passed last year, under Italian law, the actual details of how and when the Tfr payments begin to flow into pension funds will not be established until the Berlusconi government issues administrative decrees later this year. As of press time, the government and social partners were in negotiations over the shape of the administrative decrees.

The legislation stipulates that the transfer will occur via "silent assent" – workers must state in writing to their employers that they wish to leave the Tfr with the company as a book reserve, or their payments will automatically flow into pension funds. There is speculation that around half of the approximate total of €14bn in Tfr payments will flow into pension funds. It may seem surprising that it is anticipated that 50% will make the effort to ensure that the Tfr stays as a book reserve, but if left with the company, there is a guaranteed return of 2.25% – 1.5% interest rate, plus 0.75% inflation. Pension fund returns, however, are not guaranteed. Nevertheless, the pensions industry is gearing up for Tfr inflows from next year that could double the amount of assets attributed to occupational pension schemes.

"This is really the start up of the Italian pension fund system," said Luigi Ballanti, director of the Association for the Development of the Italian Pension Funds Market (MEFOP). "The annual flow of the Tfr is around €14bn or €15bn annually, and almost one half could go to the pension system. We think that from 2007, we will have an important figure, which we estimate to be an extra €8bn to €10bn in the pension system."

Increasing members key to success

An almost unanimous opinion across the pension fund industry is that while the silent assent of the Tfr payments will increase the funds that come into pension funds, there are still not enough people enrolled in a pension fund to begin with – an issue that the reforms do not address. Only around 1.4 million Italian workers had enrolled in the new pension funds by the end of December 2004, according to COVIP figures, an improvement of only 2.7% for the same point in 2003. This in a population of nearly 60m.

While the industry-wide pension funds have made strides in enrolling members – Fonchim has 62% of the energy sector employees, while Fondenergia has a 70% enrolment rate – non-unionised companies and the public sector severely lag behind in attracting employees to supplementary pension funds. There is only one public sector supplementary pension fund – Fondo Scuola Espero, for the 1.1m school employees, which was licensed by COVIP in May 2004.

Fonchim is not anticipating a large inflow of Tfr funds as a result of the 2004 legislation, but does see the need for an enrolment campaign, said Girardelli.

"We do not foresee a large amount of new Tfr contributions to come," he said. "We started in 1998 – we had €60m in Tfr contributions, €30m in employer contributions and €30m in employee contributions. In 2004, we collected €196m and gave back €46m."

Similarly, Fondenergia is not expecting a large influx of new Tfr contributions.

"As far as Fondenergia is concerned, it won't be a big increase," Stori said. "We are presently collecting around €70m per year and reckon that by the time the Tfr reform is introduced, we will be collecting approximately €80-90m per year."

'There's 43% of pay invested for retirement. What more do they want? Why give up a Fiat when you're 30 so you can drive a Ferrari when you're 67?'

Guido Blasco, Hewitt Associates

Last year's reforms are expected to partially address the low rate of enrolment by opening up competition for pension funds. Heretofore, the sector-wide pension funds, which are typically funded by trade unions, have had a contractual commitment from employers restricting them to invest through their pension funds. Non-unionised companies did not have access to these closed funds, and unionised companies whose unions said they "intended" to establish an industry-wide pension fund, but had not yet done so, could not attempt to negotiate pension arrangements with other providers. This should change, pending the outcome of the administrative decrees.

"The last important feature of the reform is the fashioning of real competitive characteristics in the pension market," said Ballanti of MEFOP. "All types of pension funds, closed and open, could be a choice for the worker. I think that competition is good in general. In this case, it is important that every pension fund really creates transparency for workers, with a proper framework, so that competition can develop without any trouble for the worker."

However, at least one consultant expressed scepticism over the ability of anyone – either government, union or employer – to convince Italians to invest more money in supplementary pension schemes.

"As of today in the state pension which is a defined contribution, we invest 33% of pay, plus the Tfr, plus the 3% contribution in pension funds, usually," noted Guido Blasco, a consultant with Hewitt Associates in Milan. "That equals out to be something like 43% of pay invested for retirement. What more do they want? Why give up a Fiat when you're 30 so you can drive a Ferrari when you're 67?"

This is the fatal flaw of the Italian pension system – in addition to accounting for a significant amount of employer and employee deductions, it is perceived to be quite generous. Although the 1993 reforms have reduced state pension payments, they will still make up around 50% of final salary for all workers with 18 years service or less in 1993.

There is a large amount of uncertainty over the short to medium term in occupational pensions stemming from the x factor of Tfr inflows, plus bigger underlying questions attributed to what many feel are inadequate tax incentives for supplementary pension savings. Currently, pension savings are taxed at 11%, and employees can only deduct 12%, or up to €5,100 on their taxes for pension fund contributions. The tax question, will particularly impact on middle managers and executives, or those making more than €50,000 annually, said Stefano Busatto, a consultant at Mercer Human Resource Consulting.

With all of these questions left unanswered, most professionals are taking a pragmatic view of occupational pension schemes' development.

"Well, it's been 10 years since I started working in asset management," said Trezzi of INVESCO. "I first started working in pension funds, and I've been waiting for 10 years for pension funds to develop. This could be probably the right time for an important change"

Rome was not built in a day, after all.

Five largest industry-wide pension funds

Name	Established	Membership	AUM
Cometa	11/11/98	320,953	€2.03bn
Fonchim	10/12/97	114,585	€1bn
Fopen	14/09/00	43,764	€369m
Fondenergia	21/05/98	29,191	€320m
Telemaco	27/10/00	58,681	€299m

Source: COVIP, all data to 31/12/04

Progress of Fonchim and Fondenergia

THE POST-1997 pension funds are dominated by the top three pension funds – Cometa, the pension fund for mechanical and engineering employees has assets under management worth €2bn. Fonchim, the industry-wide pension scheme for chemical and pharmaceutical workers, has €1bn in assets under management, and Fondenergia, the industry-wide pension for the oil and energy sector, has €320m in assets. In addition to leading the industry in size of assets and membership, these three are also noted for leading the way in diversification and consideration of new asset classes.

Fonchim, the second largest industry-wide pension fund in Italy, passed the €1bn AUM mark in December of last year. When it started investing in 1998, it offered members only a balanced fund comprising 70% bonds and 30% equities, said Andrea Girardelli, Fonchim director. In 2003, it increased those options to three – the *moneta*, which is wholly bonds, the *stabilita* balanced option, and *crescita*, with 60% equities and 40% bonds. Late last year, the fund also tendered for new managers due to the increased size of its assets under management, and now uses fund managers Sanpaolo IMI, Crédit Agricole, Duemme, Pioneer and Franklin Templeton.

"With our first targets, we were prudent, and not so sophisticated," Girardelli said. "We had no corporate bonds, no managers with equity only. We chose three balanced managers and three pure bond managers. Now we have more specialist fund managers. We have gained experience. We have also signed contracts allowing our fund managers to change the target asset allocation of the fund and explore options such as SRI, private equity and real estate."

Fondenergia also reorganised its strategic asset allocation in 2003, introducing three lines as well – a short-term cash option with bonds with less than 12 months duration, a balanced fund that is two thirds bonds, and one third equities, and a dynamic option which is 60% equities, 40% bonds.

The fund is currently considering its asset allocations, but has no plans to change its current roster of managers as they are about halfway through three-year contracts, said Alessandro Stori, Fondenergia manager. Fondenergia currently works with RAS AM, Sanpaolo IMI, Pioneer, Dexia, Duemme, ING and Monte dei Paschi.

"One goal is to study the way to reach a more efficient asset allocation, and also to consider adding alternative investment, private equity and real estate," said Stori.