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Caution over reform

The proposal for a €1bn government fund investing in SMEs has re-ignited the debate on pension fund investment limits. **Carlo Svaluto Moreolo** finds pension fund representatives cautious, but ready to argue the case for reform

The Italian government has unveiled a €1bn fund, 'Fondo Italiano di Investimento SGR', which will focus on the small and medium enterprise (SME) sector. The plan was announced in March by finance minister Giulio Tremonti. The founding members are Confindustria (Italy's entrepreneurs' association), Abi (the banking sector association), state-controlled bank Cassa Depositi e Prestiti, and banks Monte dei Paschi di Siena, Intesa SanPaolo and Unicredit.

The fund, which hopes to close its first deal by the end of the summer, will invest in companies that turnover between €10m to €100m. It will lend money to firms that want to increase their share capital or have M&A plans.

Shortly after the launch of the fund, the Milan business newspaper Il Sole 24 Ore reported that the possibility of allowing pension funds invest in private equity had been discussed at hearings with the labour commission in the lower house of Parliament.

Italy's private pension funds face stricter limitations on investment than many of their European peers. While there seems to be a consensus in the industry that easing the restrictions would be beneficial for Italy's second-pillar system, there has been little action on the political front.

Law 703 of 1996 regulates the asset classes that pension funds can invest in. It was approved as the Italian pension fund industry took its first steps, not long after industry-wide pension funds such as Cometa, the scheme for the metals industry, and Fonchim, the chemical workers' scheme, had been created. According to the law, pension funds can only invest in companies in Organisation for Economic Co-operation and Development (OECD) member states, and are

Italian pension fund investment limits

- **Italian pension funds currently face strict limits on alternative investment, Law 703 of 1996 establishes the asset classes they can invest in.**
- **Limits in investment include:**

i) Up to 10% of assets in non EU, US or Japan-traded equity and fixed income instruments issued in OECD countries;

ii) Up to 5% of assets instruments that are issued outside the OECD as long as they are traded in the EU, US or Japan markets;

iii) Funds cannot short sell stocks; investment in illiquid and risky derivatives is not allowed;

iv) No more than 20% of the fund's assets can be in cash and no more than 20% can be invested in closed investment funds

- **The Italian Parliament has recently discussed relaxing these limits with pension funds, and ways for them to invest in SMEs have been proposed.**
- **Fondo Italiano di Investimento SGR is a €1bn fund that will invest in SMEs with a turnover of €10-100m. It was created by the government, the employers' association and leading banks.**

not allowed to invest in what were perceived as riskier instruments, such as private equity and hedge funds.

The limits were based on the principle that investments for retirement and financial investment were two separate undertakings. They were decided at a time when knowledge about pension investment was limited and the size of the global financial market was significantly smaller. The blow struck by the 2007-09 financial crisis moved the issue to the bottom of the lawmakers agenda. Attempts to change it had not yielded anything before then.

Andrea Scaffidi, senior consultant at Tower Watson, believes that Italian politicians might be put off by the reputational risk that they would face in changing the regulation: "The government asks 'why do we have to do it, since nobody has done it before us?' They are worried that, if the initial impact of the changes is negative, they will be held responsible. Nobody has done much about changing the regulation so far, so they ask themselves what their gain would be if they did anything. Besides this, pension investment is a small percentage of GDP; therefore in the eyes of lawmakers it has a small impact on the real economy."

Scaffidi confirms that even recently established pension funds are putting pressure on the government, but that the political class is just not receptive to their requests.

However, while it is necessary to change the regulation, Scaffidi notes that it will take time for the changes to take effect. "The effect would be limited initially," he says. "Once pension funds are allowed to invest in private equity and real estate, it will take time before returns are interesting. Managers need expertise and track record for these investments. Also, pension funds have already fared better than TFR." TFR, or Trattamento di Fine Rapporto, is the severance pay Italian employers owe their employees. Scaffidi concludes: "Better returns would not necessarily make private pensions more appealing to workers than they already are."

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Still, now seems a good time for a change, says Scaffidi: "There is an ongoing debate within the sector. In the political sphere, obviously the experts in the ministries are more sensitive to these issues than politicians."

Marco Fusco, managing director at State Street Global Advisors, confirms that there is a consensus that the regulation should be changed. He adds the changes should especially concern the norms that do not allow funds to invest in companies outside the OECD area. "The context of investment in emerging economies has changed greatly from 1993, when the law was being written," Fusco says. "From the managers' point of view, this is certainly a limit that should be reduced. Certain funds are already assessing the possibility of investing in emerging economies within the current legal framework."

Fusco suggests that any change in the regulations should allow funds to manage risk effectively: "If the changes were orientated towards risk management, they could have a positive impact, especially if funds were allowed to exploit economies of scale and build structures dedicated to the monitoring and control of risk."

Italian lawmakers are still somewhat hesitant, but there are some signs that the presently stalled situation could change, and Italian pension funds may eventually be allowed to plan their asset allocation more freely. Many concerns have been raised, from within and outside the pension industry, that the investment decisions of Italian pension funds have a bearing on the shape of Italy's financial markets and industrial sector.

Fabio Ortolani, chairman of Cometa, Italy's largest pension fund at €5.2bn of assets

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and 470,000 members, says his fund has been involved in lobbying. "As the country's largest pension fund we have spoken to members of the Parliament, and we have said that the conditions exist to change the regulations," Ortolani says. "We have also given some ideas on how it could be done but now it is up to the authorities. It would not be a reform; rather it would be a revision of the text of the law. The Italian system has stayed in good shape, but we have to make some changes so that funds can engage with investment managers in a more productive way. Obviously certain financial instruments have not been used so far because pension investment requires transparency."

Those who advocate a change in the regulations, argue that it would be a way to spin the wheel of Italy's sluggish economy. Earlier this year, the EU Commission said that Italian pension funds should invest in Italian small and medium enterprises (SMEs), to help them through the current credit market slowdown.

These remarks did not go unnoticed in Italy. The recurrent woes about the country's SMEs, which account for a large slice of Italy's GDP, have been embraced by pension fund managers. To them, the role of SMEs is all the more important because workers of these companies do not see the benefits of investing in pension funds, and often the managers of these companies lack the capacity to educate their employees and engage in a dialogue with pension funds.

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"Pension funds could be allowed to invest in real estate and to put more resources in the equity markets"
Domenico Proietti

"The government asks 'why do we have to do it, since nobody has done it before us?' They are worried that, if the initial impact of the changes is negative, they will be held responsible"
Andrea Scaffidi

At the same time, pension funds have large resources that are only to a limited extent invested in Italy's productive economy. Their general involvement in the Italian financial markets is also limited when compared with that of their European peers.

Therefore, some pension fund managers feel that investment in SMEs would not only mean widening the investment space of pension funds. It would also be a way to avoid economic stagnation and to direct resources to where they are badly needed – in other words, the SME sector.

In recent discussions between pension fund industry representatives and lawmakers, several possibilities were explored. One was creating an asset management company that would finance public works with pension funds' assets, in a sort of public-private partnership. Public involvement in the company would serve to mitigate risk. Another proposal concerned placing state bonds with pension funds, using the proceeds to finance works or firms.

Assofondipensione, Italy's association of industry-wide pension funds proposed that SMEs issue state-guaranteed credit notes to be purchased by pension funds, which would then be financing SMEs in their investment and scaling-up plans. Assonfondipensione's president Domenico Proietti told IPE that discussions with the government and Covip, Italy's private

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pension funds regulator, are ongoing and a mere revision of the text of the 703 law would be needed.

"We think there can be a discussion on changing the regulation," adds Proietti. "The fact that Italian pension funds differentiated between the two allowed them to resist the worst financial crisis in the last 80 years. They have resisted and now they have turned the corner."

Proietti adds that when workers decide to put their TFR entitlement in a pension fund, they make an investment for retirement. If, instead, they have money to invest in the financial markets with purposes that are different from retirement, they will put it in an investment fund, he says.

"That said, there can be a discussion," Proietti continues. "Pension funds could be allowed to invest in real estate and to put more resources in the equity markets. We think the objective should always be building an income stream. Obviously workers have to exploit all the existing opportunities in order to build their income stream. But they have to do so within the limits of pension investment."

Proietti recalls that in 2007, before the crisis hit the global markets, strong pressure was being exerted on the government to change the regulation, but that Assofondipensione was less enthusiastic about relaxing the investment limits. "We were accused of not being modern enough," he comments. "The damage to the industry would have been significant if pension funds then had been allowed to invest in riskier instruments.