



## The Problem of Formation of Long-term Investment Resources Formation in the Modern Russian Economy

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### ABSTRACT

Mobilization of sufficient, long-term investment resources in the real economy is an urgent task today. Reducing the volume of investments, including due to the imposition of sanctions by Western countries, has led to a drop in production in many sectors of the economy, requiring the mobilization of domestic resources. In this connection, the article illustrates the issues of formation of long-term investment resources in the Russian economy. Special attention is paid to the fact that one of the sources of such investment is the stock market that is an alternative to bank loans. The most important entities of the stock market are the private pension funds, which functions in the scale of the national economy are not only pensions' coverage but also the investor's long-term projects coverage of financial and non-financial sectors of the economy. The article represents the analysis of the pension savings fund's activities in Russia and abroad, reveals differences in organizational and legal forms of pensions and insurance, insurance reserves and investment of pension savings. The authors develop proposals to improve the efficiency of investment activity of the pension savings fund, the use of which will increase confidence in the operating pension savings fund, and the Russian economy will get a significant increment of the long-term investment resources.

**Keywords:** Corporatization, Investment Policy, Investment Resources, Non-state Pension Funds

**JEL Classifications:** G11, G22

### 1. INTRODUCTION

The main problem of the stable development of the Russian economy in modern conditions is that the volume of investment resources of long-term character attracted to the real sector of the economy is limited. One of the resources of such investments is securities market as the alternative to bank credits, the subjects which perform the function of an investor in the projects of financial and non-financial economy sectors in the long-term. Non-state pension funds (NPFs) are the agents of the securities market-invest the resources of the pension system as a long-term resource which can actively of the projects of development of the Russian economy branches.

Scientists and politicians are engaged in the discussion of strategic perspectives of NPF functioning of the Russian securities market express two main opinions: To abolish the funded part of the pension and thereby eliminate the activity of the NPF from the

system of compulsory pension insurance or to save the funded part of the retirement pension attracting investment to pension funds and thus providing additional investment resources of the Russian economy. We support the second opinion and think that the increase of effectiveness of NPF functioning will make it possible not only to provide decent payments to future retirees but will also promote the revival of the investment climate in the country. The decrease of the volume of investments partially because of the sanctions imposed by Western countries resulted in the decrease of production in many economy sectors. In the conditions of limited external resources the accumulation of population financial resources for investment purposes becomes the priority task of the government in the sphere of development of the state investment policy. As it can be seen from the foreign experience, NPFs can play the role of financial mediators and large institutional investors and provide the Russian economy with investment resources of long-term character.

Low birth rates and increased life expectancy in Russia, as well as in Western countries lead to the rapid population aging, and, as a consequence, an increase in public spending due to rising pension payments. According to the statistics in the majority of developed countries per person older than 65 years there are 4.5 people of working age, it is expected that by 2020, this ratio could reach - 1:3.5 in the USA and 1:2.5 in the EU (Fedorova, 2008). In Russia, according to expert assessment, demographic pressure till 2007 was 578 people of non-working age per 1000 people of working age. Since 2007 this figure began to grow and in 2010 amounted to 606 people. According to the calculations of demographers in 2024 there will be 828 people of non-working age per 1000 of people of working age (Scherbakova, 2010). In the future, the forecast is also disappointing: Over the next four decades population aging will continue with all its consequences. Now pension costs in the developed countries are 9% of gross domestic product on average (about 15% in Austria, 14% in Italy, 13% in France, 6.5% in the USA, 5% in Japan and 4.5% in Canada) and 1.5% in Russia. In subsequent years these costs can increase considerably (Fedorova, 2008). Even now in many countries there is a shortage of current pension payments which could lead to increased social tension. As senior citizens are the most active part of the electorate, population aging means a significant risk of political instability in addition to economic and social problems. Therefore a detailed analysis of existing domestic and foreign experience of pension system functioning is needed to increase its effectiveness. One of the ways to improve pension provision is the development of private pension coverage and the inclusion of NPFs in the system of compulsory pension insurance.

## 2. METHODS

Studying the problem of investment resources of long-term character in modern Russian economy was based on the following methodological approach:

1. As a methodological research basis a dialectical method was used, according to which objects and phenomena are considered comprehensively, in the dynamics of development, relationship and interaction
2. For a more complete justification of qualitative and quantitative research results scientific methods of analysis, synthesis, analogy, systematic and structural methods were used. Also legalistic approach was applied
3. Particular attention within the frame of the methodology was paid to functional approach
4. The methodology of the article assumed studying national legislation and international experience in the functioning of NPF, thesis texts, reviews and articles.

## 3. RESULTS

### 3.1. Assessment of the Role and Investment Potential of NPF in the Implementation of the Investment State Policy

The Russian NPFs for the period of their functioning have accumulated significant amounts of money: 650 billion rubles in corporate pension and 900 billion rubles within the framework of

compulsory pension insurance. About 20 million people are their clients (Shperlik, 2013). This made NPF attractive for investors:

First of all, the funds could be used for assets acquisitions. For example, NPF "Blagosostoyaniye" announced its readiness to buy the shares of the company "Alrosa," NPF "Surgutneftegas" is the main shareholder of the company "UTEir," NPF "Gazfond" manage the considerable stake of "Gazprombank" (Shperlik, 2013). With the help of the funds complex transactions were made, most of which were not advertised. Therefore, business leaders seek to gain control over NPF. Nonprofit form of NPF does not allow selling or buying a fund, but it is possible to establish control over a corporation or a managing company, to have representatives in the supervisory board of a NPF.

Secondly, the money of NPF becomes the source of long-term money for the real sector of the economy, financing construction and infrastructure projects.

It should be noted that corporatization of NPF will make the relationship of the investor, the NPF and the management company more transparent. In case of control increasing by the regulator (The Central Bank of Russia) over the quality of NPF investments, pension savings as a source of funding of corporate projects will be of interest only to those shareholders whose projects have high credit quality. From the point of view of state interests and the formation of the state investment policy NPF finance can be used to recapitalize the banking system, namely, through the purchase of subordinated bank bonds. In conditions of unstable Russian economy and limited access to external markets borrowing this measure will make it possible to send retirement savings through banks for crediting enterprises and supporting the manufacturing sector.

Aleksey Ulyukaev, The Minister of the Economic Development has already announced the plans to let non-state banks buy subordinated bank bonds in order to recapitalize credit organizations. At present NPF have no right to invest pension savings in subsidized bonds as the risk is very high: In case of the bank's bankruptcy such bonds are converted into shares and shareholders are served last. Subordinated bonds provide high profitability and at the same time they are more reliable than shares.

The peculiarity of the investment activities of NPF in Russia and some other countries is the possibility not only to invest insurer funds within the country but also buy securities of foreign issuers in to save pension assets from inflation and to increase their growth rate. For example, in most countries of Latin America the limit on the investments of pension funds in the securities of other countries is up to 10% of its investment portfolio. However, in practice, the share of foreign investments in some countries is much higher. For example, in Chile at the end of 2001 foreign investments exceeded 14% of total investments of pension funds and amounted to 4.5 million USD (Rafikova, 2011).

According to the Russian Legislation, namely Article No. 26 of the Federal Law "on investing money for financing the funded part of labor pensions in the Russian Federation," "retirement savings can be placed in shares of index investment funds, which allocate them

in government securities of foreign countries, bonds and shares of other foreign issuers.” The provision of Article No. 28 of the law on investment funds about investing pension funds directly in securities of foreign issuers in the amount of not more than 20% is in force from January 1, 2010.

At present taking into consideration the difficult situation with the attraction of investment resources, the Ministry of Finance has a negative attitude to the idea of investing pension savings in securities of foreign countries. According to experts, it is important to make pension funds connected to the domestic market and work for the Russian economy according to the chart of formation of investment resources in the pension savings fund (Figure 1).

### 3.2. Estimation of the Investment Potential on the Different Stages of NPF Life Cycle

In its development NPF passes three stages, and on each stage the fund investment opportunities are realized in different ways.

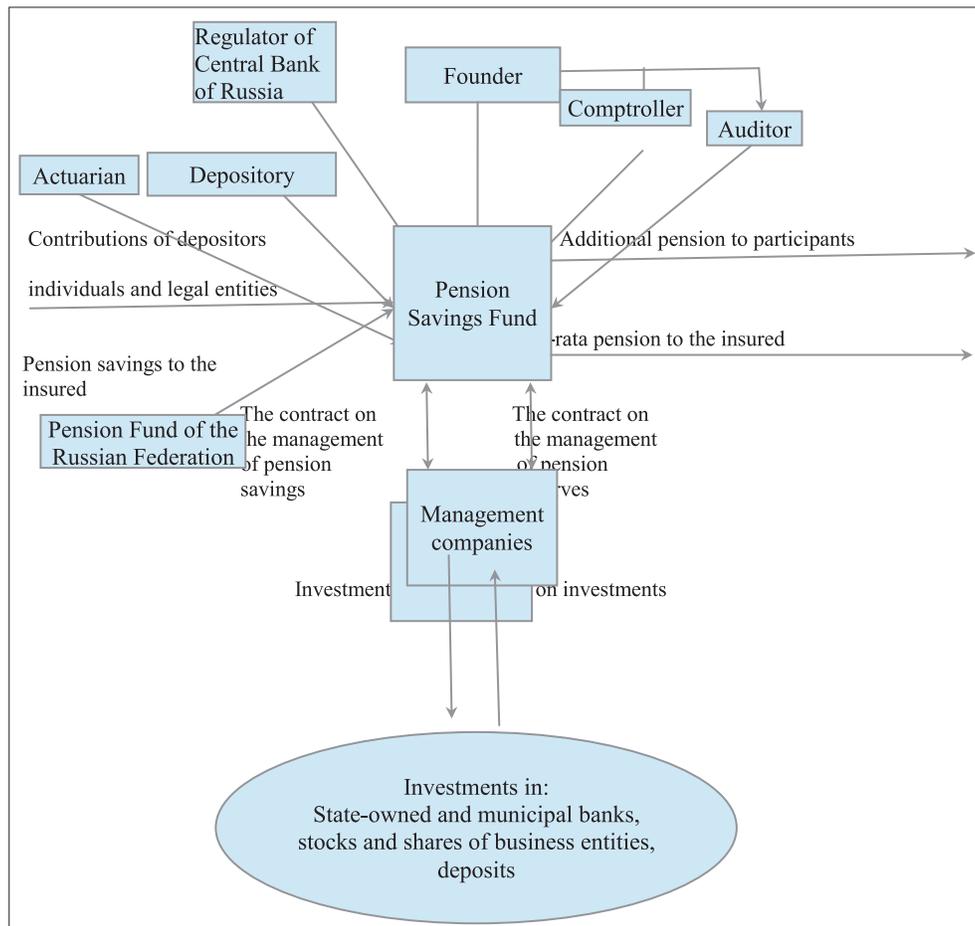
On the initial stage of functioning NPF bears substantial organizational costs associated with the state registration of the fund, getting a license, purchasing materials and technical equipment, making an advertising company. The founder of a NPF has to cover all these costs. First pension agreements and pension contributions are insignificant and have practically

unpredictable character. That is why cash flows in investments are not substantial, too.

Taking into consideration a certain mistrust of the population to NPF it is very important to provide economic support to the companies where employees participating in NPF work on the initial stage. For example, on the initial stage of functioning of NPF JSC AVTOVAZ, JSC AVTOVAZ transferred 1% from the prime cost of production to the NPF as pension contributions of their employees. So, the scheme of co-financing existed when both enterprise and a worker transferred a certain percentage of the salary to the NPF. Such mechanism of co-financing made NPF more attractive and gave additional guaranties in the reliability of NPF functioning.

The second stage of development is characterized by the increase of concluded agreements and larger volume of pension contributions. The amount of pension payments is insignificant, and is paid at the expense of current contributions, in this regard a significant portion of pension assets can be invested in the long-term, and there is no need to keep highly liquid financial instruments in the investment portfolio. Increase in the NPF assets occurs mainly by attracting new investors and to a lesser extent by income from the investment of pension assets. In terms of financial resources accumulation and their further investment this period of NPF development is the most favorable.

**Figure 1:** Formation of investment resources in the pension savings fund of the Russian Federation



Source: The figure is compiled by authors

On the third stage of NPF development the amount of pensions paid significantly increases. The number of newly concluded pension agreements reduces. Pension payments can no longer be made at the expense of current pension contributions. NPF investment must have highly liquid financial instruments for fast replenishment of financial resources.

The Investment potential of private pension funds depends not only on the stage of their life cycle but also on pension programmes, as well as measures of state support. For example, freezing of pension savings in 2013 resulted in a loss of about 500 billion rubles of pension savings according to the experts, significantly reducing the investment potential of NPF (Tarannikova, 2014).

The investment activities of NPF are defined by the chosen investment strategy, which in its turn depends on the type of market relations and the stock exchange development (Financial Analysts Journal, 2010). In the countries with a highly developed stock market NPF prefers to invest pension assets in securities and in the countries with bank-oriented model of the financial system the most preferred investment is in bank deposits (Hinz et al., 2010).

Pension funds, as the foreign experience shows, prefer less risky projects, generating regular cash flow. This is primarily exploitation of infrastructural objects. Only the largest funds can afford investments on the stage of infrastructural objects construction, for example, Canadian OPTrust specialized in energy projects. The Russian NPFs are not so large, so it is not advisable to make investments in infrastructural objects.

The Russian legislation allows Russian NPFs to invest pension reserves and pension savings in publicly traded stocks and bonds of companies related to infrastructure. It is difficult to say how actively it is done as the statistics on the sectoral structure of NPF investments is not conducted.

According to the OECD estimation, the direct investments of pension funds in infrastructural projects do not exceed 1% of their total assets (Stewart and Yermo, 2012). Among the European pension funds, only a few directly invest in infrastructural projects. These are the Dutch APG and PGGM (Della Croce, 2012).

In some countries there are restrictions on NPF investments in infrastructural projects. For example, in Brazil 20% of pension assets and in Nigeria 5% of pension assets can be invested in infrastructural funds and 15% in infrastructural bonds; in South America 5% of pension assets can be invested in shares (Stewart and Yermo, 2012) In Australia 5% of pension funds are invested in the infrastructure (OECD, 2011).

### **3.3. The Development of Proposals for the Improvement of the State Policy in the Sphere of Regulation of the NPFs Activities Aimed at the Implementation of the Investment Mechanism of Pension Assets in the Russian Economy**

Authors consider the participants of investment activities, their interests and the development history of their interaction to define the role and significance of a NPF in the investment activities and

policy of the state. It will allow formulating suggestions on the improvement of the state policy in the sphere of NPF activities regulation, in particular, investment activities in order to realize their investment abilities successfully. The first NPFs were created in the period from 1993 to 1995, as a rule, as a part of financial and industrial groups or large corporations. The founders had several purposes. The first was to make the work at the enterprises more attractive. Non-state pension programme was one of the points of the collective agreement between the company and employees. The second was to optimize the structure of the production prime cost: Enterprise expenses on deductions for private pension provision were included in the cost of production and allowed to minimize tax on corporate profits. The third task was to accumulate financial resources in the NPF of a corporation (financial and industrial group) in order to invest them in group interests. The first NPFs were created on a branch or a regional basis as a part of financial and industrial groups or established by large corporations, so the main participants of NPFs were the employees of the enterprises from the given group. This explains the significant concentration of pension assets in a small number of captive funds.

By the end of 1997, 26 funds (10% of the total) accumulated more than 86 per cent of total assets. These funds gained 81% of pension reserves of all funds, covered 47.7% of all participants of NPF and paid 83.6% of all pension payments. A similar dynamics was at the end of 2003: The largest 19 funds, each of which had more than 50,000 members, had 67% of the total number of participants, whereas the remaining 237 funds had 33%. At the end of 2005 according to the ratings, the top 10 funds accounted more than 95% of the market (Trukhachev, 2006).

The activities of the first NPFs from 1993 to 1994 was carried out in a legal vacuum, there was no necessary legal framework and measures of effective control and regulation of NPF by the state. And only the adoption of the Regulation on the Establishment of the Inspectorate of NPF under the Ministry of Social Protection of Russia, and later the Federal Law "On State Pension Funds" allowed to define the forms of control over the activities of NPF, clarified the procedure of the organization of private pension coverage, defined the status of NPF as a non-profit organization, delineated the rights and duties of those involved in the process: depositors, participants, NPF, specialized companies managing pension assets. The law clearly defined the structure of NPF management and funding of its statutory activities. Particular attention was paid to the principles of pension reserves allocation and the mechanism of interaction of NPF and managing companies.

According to the legislation the main activity of a NPF was to attract funds on the basis of agreements on non-state pension provision of the population with the depositors of the fund for the benefit of its members. Receiving pension payments from the general public or a corporation (from depositors) and accumulating funds on special accounts, NPF acts as "money saver" for the further payments of additional pensions to the citizens (participants of NPF). So far NPF as a non-profit organization could not independently engage in investment activities, i.e. to allocate funds of depositors in securities. Therefore direct investment of pension assets for the purpose of preservation and enhancement

was made by the managing company. NPFs could deposit their pension assets only in deposits of commercial banks. As a result of this distinction between the rights and obligations of private pension funds and the management company, in practice, a paradoxical situation occurred. According to the legislation NPF bears responsibility for the payment of pensions to pensioners (participants of NPF). At the same time NPF must deposit the considerable part of pension assets through managing companies which practically bear no responsibility for preservation and enhancement of pension assets. To minimize risks many NPF use the following possibility in the legislation: They deposit from 50% to 80% of pension reserves (different limits were established by the legislation at different time) independently. As a rule, selection and approval of the managing company is carried out by the founder of NPF, if necessary, he could establish a managing company. At the same time according to the current legislation the founder of NPF is not liable for the obligations of the fund. Thus, the founder of NPF selecting (establishing) a managing company practically bears no responsibility for the results of investment activities of the NPF and the managing company.

In order to minimize risks in the investment of pension assets through managing companies of NPF, it is appropriate to consider at the legislative level the following system of activities:

1. To increase the volume of own funds of the managing company (for example, the charter capital). Some economists suggest linking the amount of pension assets given to the managing company to the amount of its own funds as the future performance of pension obligations by the NPF depend on the actual actions of the managing company
2. To involve as managing companies of NPF not the newly created legal entities but organizations having at least 3 years experience of work with trust
3. To set the maximum share of a management company in the portfolio of pension assets of one fund
4. To set the requirements for reliability rating of management companies of NPF
5. To oblige managing companies to form reserve funds (for example, 10% of the charter capital)
6. To determine clear criteria for risk management standards, and IT-infrastructure of managing companies
7. Provide the elements of joint liability to clients of NPF in case of losses or reduction of pension assets given to managing companies.

### **3.4. Discussion of Foreign Experience and Activities of NPF in the System of Compulsory Pension Insurance in Russia**

According to the legislation NPF can not only deal with pensions but also carry out activities connected with obligatory pension insurance. If in the distribution state pension system the activities of NPFs were not stipulated, with the emerging of the funded part of labor pensions in the pension structure the involvement of NPF in the system of pension insurance becomes logical. The federal law from December 15, 2001 No. 167-FZ "On Compulsory Pension Insurance in the Russian Federation" (Article 32), determines that the insured person is entitled in the manner prescribed by the federal law, to refuse to receive cumulative

part of the pension from the pension fund the Russian Federation and to transfer his/her savings, recorded in a special part of the individual account to NPF since January 1, 2004. The Federal Law from July 24, 2002 N 111-Federal Law "On Investment of Funds for the Financing Funded Part of Labor Pensions in the Russian Federation," stipulates that the citizens can refuse to form part of labor pension through the pension fund of Russia and choose NPF (Subparagraph 2, Paragraph 1, Article 31).

As the analysis of foreign practice shows non-state pension insurance is performed in the form of commercial organizations. NPF and insurance companies make the institutional base of this kind of activities.

In the USA, Canada, the UK and Japan private pension insurance is performed by trust funds.

The Czech pension funds of non-state pension insurance are organized in the form of joint stock companies with a minimum registered capital of 800,000 USD (Rafikova, 2011). In Serbia companies managing voluntary pension funds are established as closed joint stock companies, the founders of which can be domestic and foreign individuals and legal entities (including banks and insurance companies). The minimum amount of company funds is one million Euro. Participation of the state is limited, legal entities in the authorized capital of which the state has the major share cannot be founders (Rafikova, 2011).

In the Republic of Croatia according to the law "On Compulsory and Voluntary Funds" pension companies are created in the form of joint stock companies and limited liability companies. It is noteworthy that the law also provides a three-tier structure of private pension funds: The board, the supervisory board and the general meeting of shareholders (Narodne Novine, 1999).

In contrast to the foreign practice in the Russia private pension funds operate as non-profit organizations and do not bring profit to their founders. Moreover, the activities of NPF are financed partially at the expense of founders contributions. Abroad NPFs should not only serve the interests of pensioners but also bring profit to the shareholders of the fund. A shareholder of a pension fund does not only have a direct benefit from the activities of non-state funds but is also responsible for its activities. In case of any shortfall in the fund (excess of pension payments over pension contributions), it is compelled to seek the means to overcome the illiquidity or cash gap.

The analysis of foreign and domestic experience revealed differences not only in the organizational and legal forms of pension schemes (insurance) but also in the distribution of investment income from the investment of pension assets. For example, in the Czech Republic the distribution of income of pension funds is as follows: 41% are taxes, 5% of the net profit goes to the reserve fund, up to 10% can be spent on the payment of dividends to shareholders (founders). The remainder of the net profit (85%) is distributed among the participants of the fund (Rafikova, 2011). The Russian legislation also provides the transferring of 85% of profit (income from investment of pension

assets) to the accounts of the participants of NPF. But 15% of the revenue from the deposition of pension assets will be directed to the provision of the statutory activities of NPF.

The research showed certain advantages of non-state pension provision (insurance) in the form of commercial organizations:

1. The economic interest of the founders (shareholders) in the fund development;
2. Vicarious liability of shareholders in case of fund shortage.

It is not by chance that the inclusion of NPF in the system of compulsory pension insurance required changes in the current legislation: Private pension funds created after January 1, 2014 must be established as joint stock companies. Funds operating before the specified date in the form of non-profit organizations must be transformed into joint-stock companies. According to experts it will make it possible:

1. To make the system of functioning of NPF clearer for investors and insured persons and more transparent for the controller (The Bank of Russia). JSC must publish the information concerning the owners; non-commercial organizations can only promulgate the names of founders who sometimes have nothing in common with the true owners. Besides non-commercial organizations unlike JSC are not obliged to publish information concerning affiliation. As a result, the change of NPF ownership as a non-profit organization is nowhere reflected, and now it is impossible to keep track who is an actual fund owner;
2. To issue and protect the rights of shareholders;
3. To attract investment through the sale of fund shares.

Experts believe that the main difficulty of the corporatization of NPF is to determine the final composition of the shareholders.

Negative effects include:

1. Increasing the debt burden of a parent company. When privatizing large state pension funds, pension liabilities of billions of rubles of NPF will become obligation for a parent company (for example, NPF "Gazfond," "Lukoil-Garant," "Blagosostoyaniye" NPF of Sberbank can increase the obligations of their company-owners). And it can negatively influence the accounting of these companies;
2. Aggravation of bureaucratic approvals when taking a decision to sell more than 10% NPF stake. According to the law a regulator agreement (The Central Bank of Russia) is needed, which increases the time of NPF entry into the ownership.

To minimize negative effects of NPF Financial Market Council corporatization, combining self-regulatory organizations and professional market participants, offers to incorporate NPF in the system of pension savings guaranteeing, but to preserve the status of non-profit organizations for corporate and captive NPFs.

#### 4. CONCLUSION

At present NPFs do not have a significant share of the financial market as state and professional economic communities do not

consider them to be a reliable investor in the real economy. But if all the proposals that are submitted by the authors of this paper are accepted and the proposed measures are implemented, it will be possible to trust the existing pension funds and the Russian economy will get a significant increment of investment resources for a long-term character. These resources will be directed on creation of a sustainable financing source to coordinate regional investment flows and help to solve important strategic problem to create a large domestic investor in the Russian economy. Using long-term investment resources of the Russian NPF that will form the required pension reserves to implement long-term economic projects, it will be possible to carry out strategic projects in the field of innovative technological development of the industry, create jobs and have a real impact on the processes of reproduction and development of the Russian economy.

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