The challenges of the private pension market in view of low interest rates and their impact on the investment market in Brazil

For decades, interest rates on Brazilian government securities were among the highest in the world, but now, with the reduction in interest rates, new investment opportunities have opened up for the private pension market in Brazil, with important repercussions for the investment market.

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Context—The size of the pension plan market in Brazil

The closed private pension market is one of the most important of the Brazilian economy. Although the amount of pension funds has reduced in recent years, as can be seen in Graph 1, the volume of resources under the administration of these entities continues to grow annually. Furthermore, in view of the growing tendency to include less favoured social classes and investments in infrastructure, it is an important source of investment for Brazil. In view of this, the gradual reduction of interest rates on government securities over the past few years presents a major challenge for managers of pension entities in Brazil that have obligations to pay their participants due to additions of retirement and social security benefits.

Several large-scale infrastructure projects are currently a priority for Brazil. This is a unique moment for the local economy, not only on account of the country's economic growth, with constant challenges in terms of oil, mineral and agricultural production, but also due to the major events to be hosted by Brazil in the coming years, such as the World Cup and the Olympic Games. Pension funds occupy a prominent position in this scenario, with demands for significant investment and, as a consequence, the development of investment solutions such as equity funds and real estate funds, among others.

The size of the market and the impact on GDP

According to the Central Bank of Brazil, local gross domestic product (GDP) reached R$4,403 trillion in 2012—approximately US$2,158 trillion—and, as shown by Graph 2, has been growing steadily over the past few years despite the global credit crisis. A major portion of Brazil's GDP is generated by its pension funds, which accounted for about 20% of GDP in 2011. This demonstrates the importance of pension funds for the Brazilian economy.

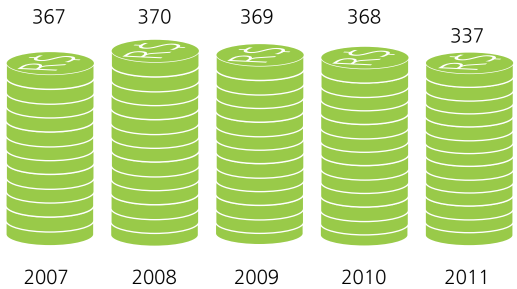
On the other hand, a considerable portion of these pension fund resources is invested in Brazilian Federal Government bonds, which have traditionally offered interest rates above the inflation rate, making them very attractive. However, as shown in Graph 3, the reference interest rate for government securities, known as the SELIC rate, began to continually and gradually fall as of 2011, as part of a monetary policy strategy aimed at reducing the financial costs of the Brazilian Government.

Pension funds, therefore, have always played a key role in the Brazilian economy because while they are an important source of funding for the Federal Government due to their purchases of government bonds, they also contribute significantly to financing various projects related to infrastructure, basic industry, highways, railways, agricultural companies, ports, hotels and other important segments of the Brazilian economy.

Consequently, Brazilian pension funds that used to primarily focus their investments in those assets as well as in shares of Brazilian companies are now faced with a major challenge, namely to find other forms of long-term investment with maturities (durations) that match their pension obligations.

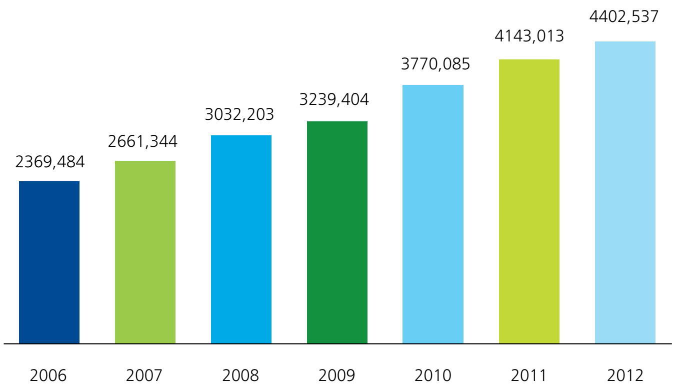
It is important to note that there are still large Brazilian pension plans which offer defined benefits to their members, where the value of the liabilities of the mathematical reserves is predetermined. Thus, the actuarial risk management assessment and impact caused by the reduction in interest rates has become increasingly challenging for their managers.

Graph 1: Quantity of pension plans in Brazil



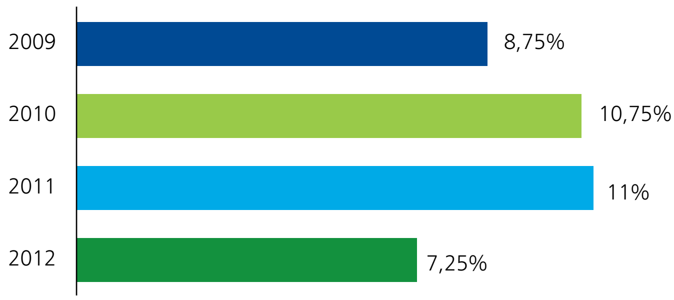
Source: National Superintendence of Pension Plans

Graph 2: GDP - Expressed in trillions of Brazilian Reais (R$)



Source: Research Deloitte (based on information provided by the Central Bank of Brazil)

Graph 3: Selic rate evolution (%)



Source: Research Deloitte (based on information provided by the Central Bank of Brazil)

The opportunity for asset managers—
Develop new alternatives for the market, matching the financial costs for the major events and infrastructure demands

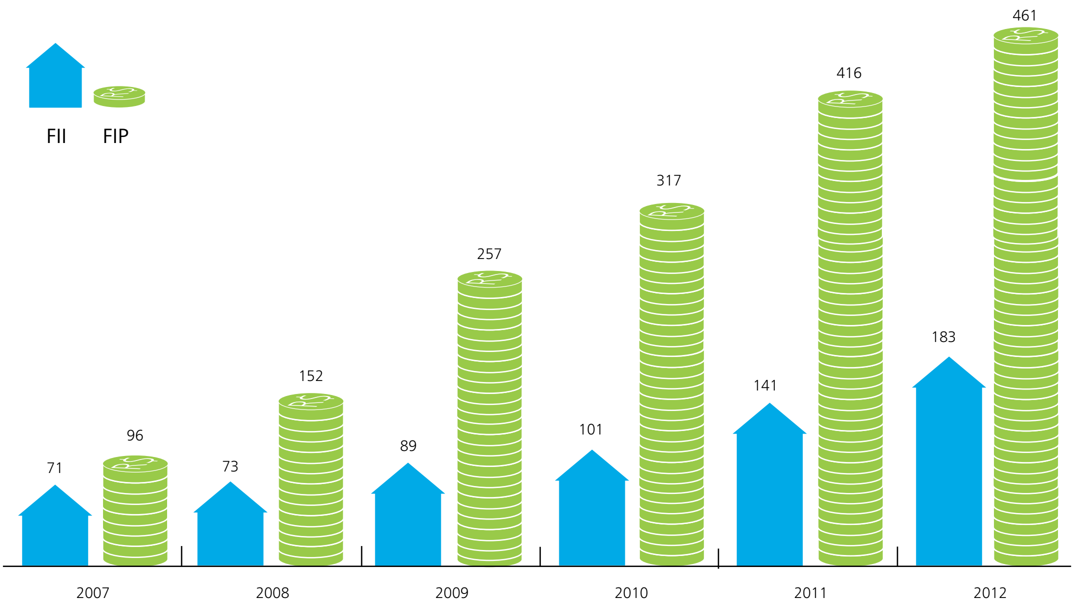
As a result, more elaborate forms of investment have been developing rapidly in the investment fund market, where large asset managers and specialised asset management companies have been swiftly identifying, developing and offering equity and real estate funds to the market and Brazilian pension funds. These strategies both combine product offerings to pension funds that come with certain risks and the promise of attractive returns and, at the same time, foster demands for financial solutions to the challenges posed by major events and modernisation projects in terms of Brazil's infrastructure base.

A significant increase in the amount of equity funds (known locally as FIPs) and real estate investment funds (FIIs) has therefore been observed in Brazil, as evidenced by Graph 4 below.

These investment funds combine customised solutions for institutional investors, including pension funds, with a clearer assessment of tax effects, which is always an important profitability assessment factor given the high tax burden, and attractive returns that are consistent with the actuarial cost of the pension funds, obviously depending on established modelling.

Of course, there are also additional investment alternatives for pension funds, such as foreign financial investments, private credit issued by Brazilian companies and also on the Brazilian stock market, which always offer upside potential in times of falling interest rates. However, all these investment alternatives are directly related to the development of the capital market in Brazil, as a result of the reduction in interest rates on government securities and also in the increase of companies listed on the São Paulo Stock Exchange (BM&FBovespa).

Graph 4: Selic rate evolution (%)



Source: Research Deloitte (based on information provided by the Brazilian Securities and Exchange Commission)

Conclusion—There is room for more solutions for pension funds following the fall in interest rates in Brazil

We should consider that employment levels in Brazil are relatively high and the population's average age is relatively young compared to elsewhere, especially European countries, in addition to the fact that the provision of social security benefits in Brazil is an important factor in retaining talent in both public and private companies. Thus, the conclusion is that demand for pension funds should remain high.

We should also consider that low interest rates in Brazil are likely to persist for a considerable period of time. Thus, the search for investments that combine market risk with returns that are consistent with the actuarial costs and durations of benefit plans will be a key theme in the pension market, with visible reflections for asset managers in Brazil in the coming years.

To the **point**:

- The size and offer of solutions for retirement plans for Brazilian citizens will increase for the next years
- The decrease of the interest rate of the public bonds will also increase the demand not just for corporate credit bonds but also for equity and real estate investment funds
- The demand for infrastructure projects and the mega events in Brazil as the Football World Cup and the Olympic Games will also generate financial solutions as equity and real investment funds