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Facultad de Ciencias Económicas
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Suggesting Guidelines for Public Pension Funds Governance

Ricardo Bebczuk, Alberto Musalem y María Luisa Streb

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Suggesting Guidelines for Public Pension Funds Governance

Ricardo N. Bebczuk, Alberto R. Musalem and Maria L. Streb[1]

Summary

Driven by the financial distress of many social security systems worldwide, national public pension funds (PPFs) have proliferated in recent years. Considering the fact that in 2007, they managed assets globally by more than four trillion and a half dollars, oversight of these pension schemes is utterly warranted. Since PPFs are ultimately financial intermediaries, strict regulation and close scrutiny of their stakeholders is desirable in order to avoid potential conflicts of interest between the owners and the managers of the funds, which are exacerbated in the case of pension funds administered by the public sector because of many reasons discussed in the paper. Governance standards should be equally rigorous as those applicable to private pension funds. Additionally, sound institutional structure is needed to keep under control undue political interference by promoting good practices of disclosure and accountability. According to several case studies, at present, national PPFs display heterogeneous standards in this regard.

In light of their size and intrinsic governance shortcomings, there exists a pressing need for ***Guidelines of Good Practices for Public Pension Funds Governance*** that lays the grounds on which these particular institutional investors should be run to achieve their stated purposes. The current document provides *Guidelines* proposing as key areas of a PPF the maximization of the risk-adjusted net return on the reserves, collections of contributions, payments of benefits, compliance enforcement, and account management. In turn, an environment conducive to the accomplishment of these objectives must be grounded on three pillars: ***(i) Internal Governance Structure****:* a good internal governance structure is one that ensures that the Fund will be administered by a committed and professional governing body where decisions are made after careful deliberation and agreement between its members in accordance to the Fund's objectives and fully consistent with the long-term commitments made to plan members; ***(ii) Investment Policy:*** a good investment policy is one that clearly and explicitly sets forth in advance the short- and long-term asset allocation, its rationale in light of the Fund's goal, the risks involved, and the tools to be used to deal with deviations from such goal; and ***(iii) Transparency and Accountability:*** it is crucial that relevant and timely information be disclosed to all stakeholders so as to facilitate monitoring and oversight of Fund authorities and actions be taken to detect and punish opportunistic behaviors and bad performance.

After listing the principles recommended for a good framework of governance, accountability and transparency, the document develops a *Manual* that complements the

[1] Bebczuk is Professor at Universidad Nacional de La Plata, Musalem is Chief Economist and Streb is Senior Economist at the Center for Financial Stability, Buenos Aires, Argentina, respectively. We greatly acknowledge the insightful comments by Robert Holzmann and Mark Dorfman from the World Bank, and Dimitri Vittas. We are grateful to the World Bank for having sponsored this research. The findings, interpretations, and conclusions expressed in this working paper are entirely those of the authors and should not be attributed in any manner to the World Bank Group.

Guidelines with its technical rationale, some operational aspects and international experience as applicable.

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I. Motivation and Background

Driven by the financial distress of many social security systems worldwide, public pension funds (PPFs) have proliferated in recent years. According to Musalem and Souto (2009), who surveyed a sample of national PPFs corresponding to sixty eight mature and developing countries, in 2007, they managed assets globally by more than 4.4 trillion dollars. Considering the fact that the authors did not include the entire population of the national PPFs in their survey, the amount is conservative. Given their remarkable size and social impact, it is self-evident that oversight of these pension schemes is utterly warranted.

On top of this, it must be recalled that PPFs are ultimately financial intermediaries. Financial intermediaries are strictly regulated and under the close scrutiny of their stakeholders. This vigilance is a reaction to well-known potential conflicts of interest between the owners and the managers of the funds. Such conflicts of interest are exacerbated in the case of pension funds administered by the public sector in view of the following features:

(i) General government authorities may be prone to interfere in order to (i) divert accumulated resources to other uses, particularly the funding of operating fiscal expenses, (ii) allocate funds to investments that are deemed socially strategic without proper regard to standard return-risk considerations, and (iii) appoint managers based on political affiliation and connections rather than skills;
(ii) PPFs face no market competition, which eliminates a major source of discipline and induced efficiency;
(iii) These funds are simultaneously sponsored and regulated by the state, thus giving rise to an obvious conflict of interest that debilitates the required control and punishment over management misconduct and ineptitude;
(iv) In those cases where the PPFs are governed by public sector wage guidelines such a wage structure curtails the ability to attract qualified human resources and provide them with productivity-linked incentives;
(v) In defined benefit (DB) systems in particular, due to the absence of individual accounts, the asset ownership is diffuse and the resulting interest in controlling the fund applications is lessened; and
(vi) Also in the case of funds covering current or future pensions in DB regimes, there may not be a readily measurable funding target against which to evaluate performance, which in turn undermines the incentives for good performance and for outsiders' disciplining over the manager.

These characteristics suggest that governance standards should be, at the minimum, equally rigorous as those applicable to private pension funds. Nevertheless, as the enforcing party, the State, is on both sides of the counter, a sound institutional structure is needed to keep under control undue political interference by promoting good practices of disclosure and accountability. At present, national PPFs display, on average, heterogeneous standards in this regard: an Index of Transparency and

Governance (TGI) estimated by Musalem and Souto (2009)[2], with ranges of values between 0 and 33, show that the highest TGI correspond mainly to PPFs of developed countries (the Superannuation Fund of New Zealand and the Canadian Public Pension Fund with 32 points, the Swedish AP1 with 29 points, the Swedish AP4 with 27 points, and the GEPF of South Africa with 27 points), while the lowest values are found in developing countries (2 points in the case of Zimbabwe's pension fund and the two pension funds from Tunisia). In this regard, according to Mitchell's (1993) findings administrative inefficiencies in public systems are not limited to developing economies. In fact, the author mentions the weak performance of US pension funds. Mitchell and Hsin (1997), argue that investment portfolios of US states public plans yield lower rates of return than portfolios of private sector pension funds. Iglesias and Palacios (2000) compared the annual compounded real publicly managed pension fund returns and bank deposit rates in 20 countries, and found that the returns of most of the sample were well below the short term interest rates, with the exception of Japan, Korea, Philippines and Sweden. Musalem and Souto (2009) show data on investment returns of national PPFs versus those of private pension systems for a few number of developed and developing countries. Subject to further statistical analysis, the small sample of data suggests that returns on investments of national PPFs in developed countries might be higher than those of private pension systems (except for the United States); while the opposite is observed for the sample of developing countries. Obviously, an important factor that might explain the above outcomes would be differential regulatory treatments.

The term "PPFs" refers here to all government-managed funds (administered either by the social security department or any other government office) as well as those that outsource the investment function while maintaining legal responsibility over the funds[3]. Impavido (2002) categorizes PPFs as funds with publicly centralized management and, hence, with governments as important stakeholders. Once met this classification criterion, the concept broadly involves defined-contribution (DC) and DB, open and closed, mandatory and voluntary, personal and occupational, and national and subnational arrangements. On the contrary, it notoriously excludes the so-called second pillar, where governance is decentralized and fund management is delegated through free choice to private (and in some cases government-owned) companies.

In light of their size and intrinsic governance shortcomings, there exists a pressing need for ***Guidelines of Good Practices for Public Pension Funds Governance*** that lays the grounds on which these particular institutional investors should be run to achieve their stated purposes. Furthermore, many PPFs have been seeking to identify a Code of Good Practices from which they can use as a basis to strengthen the Governance, Accountability and Transparency of their schemes.

The OECD has been deliberating about pension fund governance since 2000. In 2001 the Organization's Working Party on Private Pensions approved guidelines on topic that were released as OECD Recommendation (OECD, 2005). Since then, governance has risen in profile and entered the policy agenda. There has been a substantial literature on

[2] This index was first developed by Bebczuk and Musalem (2008). However, they based their estimation on about half the sample size and with a slighted different methodology as the study referred to in the text.

[3] It includes funds where the management is centralized in the hands of a legally independent authority whose governing body is subject to Government appointment. The Swedish centralized management structure with full outsourcing may be included in the definition of "PPFs".

private pension governance. In Marossy and Yermo (2001) can be found in Book 2 a compendium for Emerging Economies with a range of policy issues and comparative surveys on private pensions activities. Ambachtsheer *et al*. (2006) analyze the findings of a survey on private pension fund governance, to which an international group of senior pension fund executives responded. The authors found a positive statistical association between governance quality and private pension fund performance. Stewart and Yermo (2008), after identifying main governance weaknesses of private pension systems, suggest a balanced representation of stakeholders in the governing body, more expertise and the use of codes of conduct. Musalem and Souto (2009) study states that overall country governance has a noticeable impact on the governance structure of national PPFs. Hence, the governance framework for a national PPF may not be dissociated from country characteristics.

Although PPFs have not been at the core of the pension research agenda, some fruitful and ever-growing initiatives have been led by the World Bank, the International Social Security Association (ISSA) and the OECD in recent years. The World Bank organized in 2001, 2002, 2003, and 2004 major international conferences on PPFs governance. The contributions of the 2003 conference were collected in a volume edited by Musalem and Palacios (2004). Other valuable pieces of work prepared in-house or commissioned by the World Bank are Iglesias and Palacios (2000), Palacios (2002), Vittas, Impavido and O'Connor (2008), Bebczuk and Musalem (2008), and Musalem and Souto (2009). The ISSA issued in 2004 the *Guidelines for the Investment of Social Security Funds* on which the present work partially draws on. Alongside, ISSA (2007) discusses the results of a quantitative survey among 20 PPFs. ISSA is presently working on guidelines for the governance of Social Security Institutions, and on a review of the 2004 guidelines for the investment of Social Security Institutions. In turn, Yermo (2008) showcases the OECD work under way for this country group. Finally, Mitchell, Piggott and Kumru (2008) outlined a number of sound governance rules for pension and other public funds[4].

[4] Other publicly-held pools of assets include foreign exchange reserve funds and sovereign wealth funds. Although somewhat different in some respects, many of the guidelines enumerated in this document are applicable to these other public investment funds.

II. Structure of the Document

The Guidelines propose as key areas of a PPF the maximization of the risk-adjusted net return on the reserves, collections of contributions, payments of benefits, compliance enforcement, and account management. In turn, an environment conducive to the accomplishment of these objectives must be grounded on three pillars:

(1) Internal Governance Structure: Managing funds is an extremely complex and dynamic task requiring specific skills, market experience, and ethical integrity. A good internal governance structure is one that ensures that the Fund will be administered by a committed and professional governing body where decisions are made after careful deliberation and agreement between its members in accordance to the Fund's objectives and fully consistent with the long-term commitments made to plan members.

(2) Investment Policy: A good investment policy is one that clearly and explicitly sets forth in advance the short- and long-term asset allocation, its rationale in light of the Fund's goal, the risks involved, and the tools to be used to deal with deviations from such goal.

(3) Transparency and Accountability: Since fund managers are not the owners of the funds under their control, incentives may arise not to apply these resources in the best interest of plan members. Moreover, even well intentioned managers may turn out to be incompetent. It is crucial that information be disclosed to all stakeholders so as to facilitate monitoring and oversight of Fund authorities and actions be taken to detect and punish opportunistic behaviors and bad performance.

Throughout the document, we will generally refer to the "governing body" as the organ with authority to put into effect the necessary actions for the scheme to comply with its legislative mandate. Its responsibilities should be in accordance with the social security scheme's main objectives, which are to pay the benefits and provide the services promised. This includes both investment management and non-investment management functions. Although some of these functions may be delegated to specific departments within the Fund or outsourced, as a norm the governing body retains a veto power and thus remains ultimately liable.

The present document is divided in two parts. The first part, the *Guidelines*, just lists the principles recommended for a good framework of governance, accountability and transparency. In turn, the second part, the *Manual*, complements the Guidelines with its technical rationale, some operational aspects and international experience as applicable. Although there exist various organizational models and thus the guidelines are quite general in nature, the Manual will be as concrete and practical as possible in drafting operational courses of action (as opposed to abstract principles) that will hopefully serve for policy purposes. In the same vein, it is important to note that a good normative framework on paper is not equivalent to a successful model in practice. For the latter to materialize, an active engagement of all stakeholders and a careful implementation are required. Finally, these suggested best practices do not mean that alternative rules would inexorably lead to worse outcomes but that the likelihood is significantly higher, perhaps not in short periods but certainly over medium and long time horizons, which are the ones that matter the most in pension planning. In other words, the adoption of these guidelines should turn the pension scheme much more resilient to misconduct of any particular administration and to contexts of overall economic and institutional fragility.

III. Guidelines of Good Practices for Public Pension Funds Governance

Overriding Objective: PPFs should maximize risk-adjusted net return to plan members, together with collecting, managing, benefit processing and disbursement.

1. Internal Governance Structure

1.1 Prerequisites for good governance

The governing body, managing institutions and contracted service providers should be vested with the power and resources to comply with the legislative mandate of the Fund and should also be accountable whenever it fails to meet its legal obligations.

1.2 Governing Body

The Fund should be administered by a specialized governing body, or by a government office with comparable conditions of professionalism, incentives, integrity, resources, and political independence.

1.3 Investment Mission

In accordance to the Fund's objectives, the investment of the resources trusted to the Fund is a prime mission. Funds usually have boards that set investment policy and investment committees.

1.4 Recruitment Policy

The nomination, appointment and dismissal of members of the governing body should be conducted on a transparent and merit-based manner.

1.5 Auditing

An internal auditor, independent of all stakeholders, should be appointed to carry out the oversight of the financial, accounting, and legal processes. In turn, an Audit Committee should review the performance of the internal auditor.

1.6 Actuary

An actuary, independent of the governing body and its authorities, should be appointed to determine the financial solvency of DB Funds.

1.7 Custodian

Custody of the Fund assets should be trusted to a private or public institution with proven record in providing these services. Fund assets should in all cases be legally independent of other assets the custodian may be responsible for. Fund assets should be legally independent of the assets of the managing institution.

2. Investment Policy

2.1 Investment Policy

The governing body should set forth in a written statement and actively observe an overall investment policy aimed to attain the Fund's objectives.

2.2 Prudent-person Principles and Quantitative Restrictions

The investment policy should be guided by a prudent-person standard. Quantitative restrictions may also be put in place as long as they do not inhibit the pursuance of the Fund's objectives, or when the internal governance structure and/or the degree of transparency and accountability are deficient.

2.3 Benchmarking

The investment policy should determine operational financial targets or benchmarks against which the Fund's financial performance can be measured up.

3. Transparency and Accountability

3.1 Disclosure and Reporting

The governing body should disclose all relevant information to all parties involved in a clear, accurate and timely fashion.

3.2 Relationship with the Executive

The Fund operations should focus on fulfilling its legislative mandate and therefore should be subject to the least possible political interference.

3.3 Relationship with the Legislative

The governing body should report to the Legislative Power on a regular basis as a means of establishing proper checks and balances against inappropriate political interference by the Executive.

3.4 Relationship with plan members

Plan members and beneficiaries should be provided with all relevant information for making, if applicable, fully informed choices.

3.5 Redress

Scheme members and beneficiaries should be granted prompt statutory redress mechanisms through a body established for this purpose or through the courts.

3.6 Regulation and Supervision

The Fund should be under the regulation and supervision of the organism that oversees other pension schemes in the country. Otherwise, it should be subject to the oversight of one of the financial regulatory agencies in place.

3.7 External Audit

The Fund's accounting statements must be certified by an external auditor with adequate credentials. The audited statements should be disclosed along with all observations the external auditor might have made.

3.8 Effective Accountability

The governing body should be accountable to plan members and the competent authorities. Furthermore, the legal framework, the statute and the by-laws of the Fund should clearly state the criteria used to judge the performance of the governing body and the penalties applicable.

IV. Manual of Good Practices for Public Pension Funds Governance

The core objectives of the PPFs should be toguether with collecting, account managing, benefit processing and disbursement, to strive for obtaining the maximum net return for a previously agreed level of risk. The net rate of return should be no less than the covered wage growth in DB schemes. Similarly, the fund should seek to maximize the rate of return realized in each asset class, with the asset allocation undertaken in accordance with a framework which assesses both the evolution of the DB scheme's liabilities as well as the historic and projected risk and return profiles of different asset classes. While in the DB case the risk is pooled and in the DC it is born by the individual.

In DB schemes, no preferences need to be identified. The strategic asset allocation can be developed within an Asset and Liability Management (ALM) framework, where the overall risk is determined in terms of the consistency between assets and liabilities on the funds balance sheet. Even in a DC regime based on individual accounts, plan members differ in their preferences because of their age, risk attitude, financial sophistication and rationality. Still more complex is the case of a DB system, where there is no strict correspondence between contributions and benefits, and reserves are intended to fund current or future pensions. Still the appropriate risk tolerance as well as target returns for different asset classes can be determined. For example, in private DB schemes, actuaries use the projected wage growth plus a factor (often 150-250 basis points) as the assumed rate of return for a scheme. With this assumption, they determine the funding strategy and sufficiency of reserves. The supervisor can review this and other assumptions used. Similarly, it is possible to use such a threshold as one performance benchmark for performance of a public scheme. In addition, since public schemes guaranteed by the Government (Govt) are setting aside fiscal resources for the future, some countries use the long term (LT) rate of return on Govt LT securities as a performance benchmark. Of course investing in Govt paper would be less risky than commercial debt or equity but the projected cost of debt can serve as a basis for expected returns and, in addition historic volatility on government paper can be used as a basis for anticipation of volatility on similar assets.

As mentioned by Musalem and Pasquini (2009) DB pension funds were badly hit by declines in equity prices and interest rates at the beginning of the current century. This gave way to a switch form DB to DC plans in many firms around the world in order to avoid the International Financial Reporting Standards (IFRS) requirements. This process was accelerated by the recent financial crisis. The mentioned authors cite Ponds and van Riel (2007) which describe the Dutch pension systems as a passage from an end-of-period-pay DB schemes to average-pay DB system with DC elements as a hybrid system; thus introducing a risk sharing mechanism among participants and sponsors.

The governing body should in advance provide stakeholders with an operational definition of the sought risk-adjusted net return, so as to allow the latter to scrutinize investment performance. This definition may be given in the form of an absolute real return or a benchmark index. For additional guidance on potential benchmarks see

Investment Policy section below. Regardless of its particular formulation, it is crucial that the objective be quantifiable and easy to understand and monitor by all stakeholders.

It must also be noted that the Fund should maximize *net real* returns, that is, gross returns minus operating and administrative costs, expressed in inflation-adjusted local currency terms. This measure emphasizes the need to simultaneously maximize returns and minimize the associated management costs. In the case of DC schemes it reflects the impact on members' future consumption.

As said before, the governing body besides concentrating its efforts on financial returns must be held accountable for collections of contributions, benefit processing and disbursement, compliance enforcement, account management, and other related functions of social security institutions. Given their social and political connotations, these roles may threat the technical independence required for a wise portfolio management, by inducing other actors -most notably the government, the labor unions and the employer associations- to demand direct participation in fund management decisions without having the specific expertise in financial matters. While the separation between portfolio management and other pension-related tasks is clear-cut in DC regimes, this may be questionable in DB systems, where funding requirements create a linkage between financial management and benefits. However, the legislative framework should clearly establish the different functions of the pension regimes. The core objectives of the PPF should not include other development objectives such as improving the country's economic development or investing funds for any purpose beyond risk-adjusted net return maximization.

1. Internal Governance Structure

1.1 Prerequisites for good governance

The governing body, managing institutions and contracted service providers should be vested with the power and resources to comply with the legislative mandate of the Fund and should also be accountable whenever it fails to meet its legal obligations. The standard upheld to Board and Management members of a public scheme embodies the concept of exercising "duty of care". Under this principle, a member is requested to exercise the duties with honesty and diligence, seeking the best interests of the social security scheme and its members. Accountability requires no political interference.

Over and beyond the particular governance structure chosen, it is essential that the governing body satisfies some prerequisites for doing its job (see Box 1). These conditions include:

(i) *Powers and Responsibilities*: Legislation, institutional policy or decree must establish the grounds for the powers and responsibilities of the Board and Management, with a clear separation between both[5].

(ii) *Adequate accountability rules*: The counterbalance of legal powers must be the disciplining power exerted by the government and other stakeholders in case the governing body does not comply with its mandate. This clearly contributes to align the incentives of all parties involved. However, as will be explained in more detail later on, sanctions should be triggered when acting in bad faith or in the event of long-term underperforming. Nevertheless, penalties should avoid inhibiting financial innovation and reasonable risk-taking.

(iii) *Political and budgetary independence*: Letting alone the rights and obligations prescribed by the law, the governing body should not be subject to government interference with its portfolio decisions. Although the government should retain the right to request explanations from the governing body, it should not be allowed to request prior approval or veto actions already taken. Financial decisions should be as free as possible from political or strategic goals other than maximizing the risk-adjusted net return. To this end, it is desirable that the Fund have its own budget, financed with Fund's resources under rules and the scrutiny of the competent authorities, in particular the Congress. The underlying reason is that when Fund expenses are covered with general fiscal revenues, the government is more able to coerce the governing body into following its directives.

(iv) *Financial and technical resources*: The governing body should be supplied with sufficient resources to recruit qualified personnel, seek the advice of outside experts, acquire state-of-the-art information and communication technology (ICT), and make other critical expenses needed to accomplish its goal.

5 While the Board refers to the governing and policymaking body of the Fund, the Management is in charge of the PPFs' administration and implements the Board's resolutions.

(v) *Professionalism*: Financial decisions must be in the hands of highly professional fund managers with proven experience in the field. It must be clear from the outset that, regardless of the social implications of a pension system, managing a pension fund remains exclusively a financial matter. If possible, the key governing body members should be selected from among prominent market players, not only because this is a signal of good track record but also because these executives face a larger reputational cost in case of failure, which increases their incentives for better performance. Furthermore, besides being politically independent, managers should be independent from the financial industry, so as to prevent self-dealing and other transactions with related parties at the expense of the affiliate.

(vi) *Incentives*: To avoid the low productivity syndrome often attached to public sector jobs, the members of the governing body should be equipped with correct incentives to perform. Competitive wages with a partial component of performance-based, variable income should be part of the package, along with the previously mentioned negative incentives – i.e., reputational costs and legal liability. The latter implies that there should be an external authority that takes legal actions against the Board or Management and that it may have a protection for whistleblowers.

Box 1: Canada's Pension Plan Investment Board: Management & Governance

The Canada Pension Plan (CPP) is a defined benefit plan providing pension established in 1966. In 1996, an actuarial report projected the plan's small contingency reserve would be exhausted by 2015. A year later, the provinces and the federal government reached agreement on deep reforms to the CPP that gave way to the creation of the CPP Investment Board.

"The distinct governance model of the CPP Investment Board, one that balances its arm's length relationship with governments with strong public accountability, is set out in legislation.

- *The investment professionals of the CPP Investment Board report to an independent board of directors.*
- *Directors are appointed by the federal finance minister in consultation with his counterparts in the participating provinces and assisted by an external nominating committee with private sector involvement… (see Box 4, Section 1.4).*
- *...The board of directors hires the CEO, sets investment policies, reviews performance, approves external investment management partners, sets compensation for management linked to long-term performance and appoints independent auditors.*
- *The composition of the board and the amending formula for the legislation keep the operations of the CPP Investment Board independent from governments.*
- *A stringent code of conduct compels members of the board of directors and management to report any attempted political influence of investment decisions.*

The CPP Investment Board is a professional investment management organization. There are at least four key attributes that distinguish it from Sovereign Wealth Funds and other forms of state-sponsored funds.

- ***Governance structure***. *The CPP Investment Board's governance model was designed to prevent political interference and is enshrined in the Canada Pension Plan Investment Board Act.*
- ***An investment-only mandate***. *By design, CPP Investment Board decisions are not influenced by government direction, regional, social or economic development considerations, or any other non-investment objectives.*
- ***Transparency***. *The CPP Investment Board disclosure policy states: 'Canadians have the right to know why, how and where we invest their Canadian Pension Plan money, who makes the investment decisions, what assets are owned on their behalf, and how the investments are performing.' This belief is demonstrated by more than 1,200 pages of disclosure on the CPP Investment Board website, mandatory quarterly and annual disclosure of financial statements, and the public disclosure of portfolio holdings.*
- ***Segregated assets***. *Unlike sovereign funds, Canada Pension Plan assets are not government assets and are not dependent on tax revenues. The Canadian government is neither a sponsor nor guarantor of the plan."*

Source: http://www.cppib.ca/files/PDF/fact_sheet_q3_2010.pdf

1.2 Governing Body

The Fund should be administered by a specialized governing body, or by a government office with comparable conditions of professionalism, incentives, integrity, resources, and political independence.

Several good practices have been advanced by ISSA and OECD to deal with the notable conflicts of interest that appear in PPFs. One of the most important issues, developed recently, that countries have to deal with is the independence of the governing body of the PPFs from excessive political interference. The fiduciary law should determine the Board's responsibilities and make them accountable. It is essential a clear process for the appointment of capable board members together with transparent procedures for their removal and performance evaluation system.

The governing body can be either a government ministry (such as the Ministry of Social Security, Labor, or similar), the Social Security office (usually with the status of a Secretary or Under-Secretary within a Ministry), or an autonomous entity. A priori, in most cases an autonomous entity appears as the preferable option for several reasons (see Yermo, 2007): (i) it has greater clarity in mandate and objectives, insofar it can be kept from being involved in other pension-related tasks; (ii) for similar reasons, it is more transparent and accountable; (iii) it is more independent from government influence; and (iv) it has more flexibility in recruiting and compensating qualified human resources, most needed in the board and senior management positions.

Nevertheless, in practice, the prevailing model by far is a tripartite board composed by representatives from the government, employers, and workers. The tripartite model may suffer government intervention that, as pointed out earlier, may result in inefficient outcomes. There is no guarantee that seats in the board are granted to individuals with financial and pension-specific background. Musalem and Souto (2009) found information about the composition of the decision making bodies of 69 PPFs, where 43 of them had the so-called tripartite body. While in some funds the representatives were chosen by their respective constituencies, in others they were appointed at the government discretion. Such is the case of Bahamas, Bahrain, Malaysia, Nepal, and Philippines among others. The authors highlighted that only in few countries, e.g., Canada, Ireland, and New Zealand, the board members were nominated by their professional qualifications rather than by a particular constituency, in order to assure autonomous management (See Boxes 2 and 4 in Section 1.4, and Box 12 in Section 3.2).

Indeed, in many countries the approach in terms of tripartite governing body should be reviewed to enhance independence and accountability as well. In countries where it would be politically unfeasible to avoid the tripartite board, a compromising alternative would be to vest it with a supervisory role, with no material bearing on investment policies except for consultative or formal enactment purposes, while appointing a sound governing body in charge of setting out the major investment guidelines. Additionally, external experts should be used regularly in the definition and accomplishment of PPFs policies.

Box 2: Diversity in the appointment of board members

The Board of Directors of Employees Provident Fund (EPF) of Nepal forms "the top most level in the hierarchy of the organization structure of EPF. The Board of Directors of EPF is constituted of the following seven members: a Chairman appointed by Nepal Government, three Directors nominated by Nepal Government from different government services, two Directors nominated by Nepal Government from banking, financial and corporate sectors, Administrator of KSK."

Source: http://www.epfnepal.com.np/Pages/Content/Board.aspx

In Ireland, "the members of the National Pensions Reserve Fund Commission are appointed by the Minister for Finance. Under the National Pensions Reserve Fund Act, the Minister may only appoint people with substantial expertise and experience at a senior level in a number of specified areas as follows:

- *investment or international business management,*
- *finance or economics, the law,*
- *actuarial practice,*
- *accountancy and auditing,*
- *the Civil Service, trade union representation,*
- *the pensions industry,*
- *consumer protection."*

Source: http://www.nprf.ie/Commission/commission.htm

1.3 Investment Mission

In accordance to the Fund's objectives, the investment of the resources trusted to the Fund is a mission of the governing body besides other functions (e.g., collections of contributions, payments of benefits, compliance enforcement, and account management).

The provision of pensions involves multiple and heterogeneous tasks, including actuarial assessments, the actual collection and payment procedures, and the investment of idle resources and member contributions. The fund management mission is quite specialized and should be conducted independently of other social security activities. This is, as a matter of fact, a basic cornerstone of financial intermediation: the intermediary (be it a bank, an insurance company, or a pension fund, for that matter) is not concerned about the income and expenses of the investor, but only cares about how to allocate the funds according to the investor's preferences. In the social security arena, the concentration of these assignments in only one organism may bring about conflicting results: just as an example, in DB systems under financial distress, there may be some pressure to boost returns even at the price of excessive risk-taking and against the best judgment of the fund manager.[6]

Regardless of the internal organizational structure, the ultimate responsibility for the investment decisions should lie with the governing body. This point is not trivial, as the governing body may delegate investment strategies and asset selection to specialized firms. The first best is to appoint a competent governing body with the required financial background, and creating an Investment Committee in the board for a closer oversight and performance evaluation. This is efficient because it simplifies the decision process and because incentives are better aligned when the decision making and the legally responsible units are the same[7] (See Box 3). This is not to say that the governing body should not seek the advice of outside specialists and scholars –who may be even summoned to integrate a stable Consultative Investment Panel- nor that it should not consult with authorities and regulators in the financial area. Much to the contrary, these exchanges are likely to become a valuable contribution, particularly at the stage of designing or revising investment policies. Of course, the weaker the financial orientation of the governing body, the stronger the need to outsource this function to market experts.[8]

[6] It can be argued that the same kind of pressure on the Fund's financial policy can be exerted by the government social security office. But the difference is that, being a different institution and provided that the government body has enough autonomy, the Fund may refuse to engage in investment strategies that are considered too risky.

[7] This is especially important in designing the long-term portfolio strategy. The particular asset selection emerging from such policy choice may more easily be trusted to first-rate global fund managers.

[8] When the whole financial portfolio strategy and fund management functions are outsourced, the obvious emerging question is what role the governing body actually plays.

Box 3: Chile's Pension Reserve Fund
Investment Committee

The Pension Reserve Fund of Chile benefits from a Financial Committee. This Committee "provides advice to the Ministry of Finance on the fundamental aspects of the investment policy… The Committee is made up of renowned professionals with extensive experience in the areas of finance and economics.

The Committee meets to discuss and adopt recommendations to be submitted to the Minister of Finance for approval… by law the Committee should meet at least once every six months…

The Financial Committee is supported by a specialized team from the Ministry of Finance that is led by the International Finance Coordinator. The team is also made up of several economists and a lawyer from the International Finance Unit, as well as the head of the Budget Office Public Finance Division, the head of Finance Programming and two analysts from that division.

In order to ensure transparency the Committee publishes all of the minutes of its meetings and makes public statements on its main recommendations on investment policy for the funds. Annually it reports on the state of the funds to the Finance Ministry, to Finance Commissions of the lower house of Congress and the Senate, and to the Special Joint Budget Commission of Congress."

Source: http://www.minhda.cl/english/fondos_soberanos/comite_financiero.php

1.4 Recruitment Policy

The nomination, appointment and dismissal of members of the governing body should be conducted on a transparent and merit-based manner.

The success of a Fund, whatever the chosen organizational structure, crucially depends on the ability to recruit well-trained and engaged financial experts and to get rid of those who do not perform as expected. In order to limit discretionality and political interference, the legal framework must clearly specify the ethical and professional basis under which members to the governing body are to be nominated and appointed, as well as the reasons for dismissal. As some activities may be outsourced, the law in general and the subsequent normative should establish the precise rules governing the hiring and dismissal of outside managers and consultants.

The starting point is to set up a Nominating Committee (see Box 4, and Box 12 in Section 3.2) within the governing body to take care of submitting a list of candidates, assessing performance while in office, and advising the destitution of incompetent or dishonest ones; the Committee may also have a say in shaping the salary structure. Once again, in politically appointed boards (as is usually the case in the tripartite model), the Nominating Committee should incorporate or seek advice from well-informed market participants to identify the best candidates. Being the Fund in the realm of the public sector –which is not the same as saying that it is a government office-, official appointments and dismissals may be formally made from among the proposed candidates by the President with Congress agreement. The term for these appointments should be limited (say, 3-4 years), but with the option to be reappointed for successive terms. In this way, there may be room for removing unfitted members while preserving and capitalizing on the experience of the good ones.

Principles that should be taken into account are: (i) representatives of specific stakeholder group must have a verifiable process with which one can determine they are representing such groups; (ii) there should be terms which overlap the maximum period of governing for the legislative and executive branches; (iii) If appointed by the President or Prime Minister, removal should be only for just cause, for which standards would be proscribed; and (iv) 3rd party verification of minimum professional and ethical standards is essential.

Box 4: Canada´s Pension Plan Fund
Nominating Committee

Directors of the Canada Pension Plan Fund "are appointed by the federal finance minister in consultation with the participating provinces, and with the assistance of a nominating committee, for a term of three years.

The nomination process is designed to ensure that only those with expertise in investment, business and finance are appointed to the board.

The chair of the nominating committee is federally appointed, and each participating provincial government appoints one representative. The nominating committee recommends candidates for appointment and re-appointment to the federal finance minister. In turn, the federal finance minister makes the appointments in consultation with the provincial finance ministers.

The legislation disqualifies certain individuals from being directors…

… The board conducts a confidential annual peer review to assist each director in identifying self-development initiatives and assist in providing the external nominating committee with guidance when it considers individual re-appointments"

Source: http://www.cppib.ca/About_Us/about_our_board.html

1.5 Auditing

An internal auditor, independent of all stakeholders, should be appointed to carry out the oversight of the financial, accounting, and legal processes. In turn, an Audit Committee should review the performance of the internal auditor.

As in other organizations, the internal auditor should be empowered to overseeing the reliability of financial reports, the disclosure practices, the internal control and risk management systems, and the regulatory compliance if applicable (see Box 5). Eligibility criteria should be similar to those for members of the governing body, except that the very governing body should be responsible for the appointment. The auditor must report his or her findings to the governing body, calling special attention on negative developments and recommending appropriate remedial actions. If these are not promptly taken, the auditor should report to other competent authorities. The existence of an Audit Committee is highly desirable. This Committee, formed by members of the governing body and/or outside specialists, should review the performance of the internal auditor and also participate in the choice of the external auditor.

The external auditor should satisfy minimum requirements, such as professionalism and code of conduct, and legal liability for good faith disclosure.

Box 5: The Finance and Audit Act of the National Pensions Fund of Mauritius

The Committee that administers and manages the National Pensions Fund of Mauritius (NPF) "shall not later than 3 months after the end of every financial year, prepare and submit to the Director of Audit- (a) an annual statement of the receipts and payments of the Fund for that financial year; and (b) a balance sheet made up to the end of that financial year showing the assets and liabilities of the Fund.

... The Committee shall, as soon as practicable after the end of every financial year, furnish to the Minister- (a) a report on the activities and financial position of the Fund during that financial year; and (b) a copy of the audited accounts of the Fund for the financial year together with the auditor's report on those accounts.

The Minister shall, at the earliest available opportunity, lay a copy of the annual report and audited accounts of the Fund before the Assembly.

Source: http://www.gov.mu/portal/goc/ssns/file/welfareelderlyreg.pdf

1.6 Actuary

An actuary, independent of the governing body and its authorities, should be appointed to determine the financial solvency of defined benefit funds. (see Box 6).

Actuarial services should be hired in DB schemes to assess financial solvency in the face of uncertainty regarding mortality, fertility, unemployment, income and other variables with direct impact on contributions and benefits in the short- and long-term. The governing body must be kept informed about actuarial sustainability of the system in order to adjust its investment policies if deemed necessary, and inform the responsible authorities to take immediate action to correct deficiencies. If the Fund is responsible for setting contribution and benefit levels (which is not advisable, as forcefully argued earlier), the actuary must report directly to other competent authorities and stakeholders if the governing body does not take into account his or her recommendations. An Audit Committee (formed by members of the governing body and/or outside specialists) should review the performance of the actuary and be involved in the actuary selection process. In case of need this committee could also hire an external actuary to benefit from their technical opinion.

The actuarial review process is an essential part of the review of the disability and survivorship benefits, sufficiency of funding etc. and reviewing the assumptions and parameters for annuities in DC schemes.

Box 6: Final Report of the actuarial valuation of the Disability, Old-Age and Death Insurance Reserve Fund of Costa Rica

"In turn, the Superintendency of Pensions, hired the Mexican firm Nathal Actuaries and Consultants, to conduct an actuarial study to the Disability, Old Age and Death Regime.

The document was challenged by the actuaries of the Social Security Costarrience Fund (CCSS), because, in their view, it has serious conceptual and methodological shortcomings.

The matter will be settled by a report prepared by the highest ranking expert in the field: the International Labour Organization.

Under the principle of transparency, both the signature Nathal report and the comments to this final report, by the actuaries of the CCSS are presented" in the following link:

http://www.ccss.sa.cr/html/transparencia/transparencia.html

1.7 Custodian

Custody of the Fund assets should be trusted to a private or public institution with proven record in providing these services. Fund assets should in all cases be legally independent of other assets the custodian may be responsible for and independent of the assets of the managing institution.

A custodian institution should be designated to safekeeping the Fund's assets (See Box 7). There are three sets of functions which are subject to their own standards: (i) the custodian should be responsible for the safe-keeping of financial and non-financial assets and be subject to a series of custody requirements and be subject to a number of disclosure requirements; (ii) a bank or other financial intermediary may be contracted to manage the receipt of transfers, contributions and disbursal of benefits; and (iii) a separate information manager or service provider can be contracted for the purposes of disclosure of individual entitlements or of collective account information or both.

These funds should be maintained in a legally separated account from other assets held by the custodian in order to isolate the Fund assets from the default risk of the custodian. As it is likely that this role be reserved to a public sector-owned bank, which in turn have governance problems of their own and are usually subject to heavy government influence, it is important that all legal and accounting safeguards be taken to discourage the misuse of the Fund's assets.

Box 7: Custodian institution of the Employees' Provident Fund of Sri Lanka

In terms of the Section 5 of the Employees' Provident Fund (EPF) of Sri Lanka Act, No. 15 of 1958, "the Monetary Board of the Central Bank is vested with the responsibility… as the custodian of the Fund, (besides)…investing the excess monies of the Fund in securities as the Board may consider fit and sell those securities. The overall investment process with the investment objectives and the guidelines has been explicitly stipulated in the Investment Policy Statement of EPF".

Source: http://www.epf.lk/A_Fund_mgt21.htm

2. Investment Policy

2.1 Investment Policy

The governing body should set forth in a written statement and actively observe an overall investment policy aimed to attain the Fund's objective.

The document should include the long-term asset allocation by asset class and its rationale in light of the goal of maximizing the risk-adjusted net return. The document should provide some indication of the desired risk and return profile of the Fund, and the justification for it. The investment policy should establish clearly the financial objectives of the Fund and the manner in which those objectives will be achieved. The investment objectives should be consistent with the retirement income objective of the Fund, and thus should satisfy, in addition to the relevant legal provisions; the principles of diversification and matching of assets and liabilities if applicable (see Box 9 in Section 2.3).

Pension programs vary in design, but usually they are classified in two broad types: DC and DB. Under a DC plan, each employee has an account into which the employee (and/or the employer) makes regular contributions. Benefits depend on total contributions and net investment earnings of the account. The employee bears all the investment risk and the retirement account is by definition fully funded. A DC plans investment policy is similar to that of an individual deciding how to invest the money in an Investment Retirement Account (Bodie, 1988).

Under a DB plan, the employee´s pension is determined by a formula that takes into account years of service and salary. The pension promised to the employee is the PPF´s liability. DB pension funds are pools of assets that serve as collateral for these liabilities. Beneficiaries presumably want pension plans to be as well-funded as possible. However, their preferences with regard to asset allocation policy are less clear. Literature seems to view, in the case of private sector´s pension liabilities, as divided into retired and active. Pensions owed to retired participants are nominal, and pensions accruing to active participants are real. The nominal benefits can be immunized or hedged by investing in fixed-income securities with the same duration or the same pattern of cash flows as the pension flows. Accruing pensions have a very different investment policy: "an actuarial interest rate" assumption becomes the target rate for the pension asset portfolio. The possibility of receiving a rate of return below or above the actuarial assumption will affect the asset allocation decision favoring an asset portfolio with a truncated and positively skewed probability distribution of returns (Bodie, 1988).

The investment policy for DC programs in which members are allowed by law to make investment choices (multiple funds) –although unusual at present among PPFs- should ensure than an appropriate array of investment options, including a default option, are provided for members and that members have access to the information necessary to make investment decisions. In particular, the investment policy should classify the investment options according to the investment risk that members bear (Bodie, 1988).

It should also contain the associated means of monitoring performance in absolute terms as in relative terms to the benchmark, managing risks, and reviewing the policy in place if needed. Legal and normative provisions affecting the investment policy, most notably the existence of quantitative restrictions, must be clearly highlighted and its expected impact on portfolio profitability, security and liquidity explained. The document should be approved and issued by the governing body, which should also be the ultimate responsible for its content, regardless of whether the actual drafting is commissioned to a third party in the event that the governing body members (even those composing the Investment Committee) lack the required technical stature.

Finally, as far as implementation is concerned, the investment policy should address: (i) how assets are priced: for traded and liquid securities, market values should be used; for illiquid assets, a fair valuation methodology, properly disclosed and tested, should be adopted; and (ii) whether internal or external investment managers will be used, the range of their activities and authority, as well as the process by which they will be selected and remunerated and their performance monitored.

At the international level, it is uncommon to find PPFs that observe these principles (see Bebczuk and Musalem (2008) and Musalem and Souto (2009)). Funds do not publish a detailed investment policy, although in some countries, particularly in the OECD area, annual reports give a loose account of the current and future strategy. Governing bodies are probably reluctant to provide more information because of the fear of being held liable for an inferior outcome vis-à-vis the proposed strategy.

However, it must be clear in the eyes of all parties involved the distinction between the investment policy and the investment performance. An investment policy is a strategic plan consisting of allocations and risk management mechanisms, founded on historical and expected returns and the needs and preferences of plan members. The investment performance is the realized outcome that may or may not coincide, period after period, with the expected one. Over long periods (say, at least 3-5 years), actual performance should be more or less in line with the benchmarks established in the investment policy, and that is why public knowledge of the latter helps assessing the governing body. This implies that legal provisions and stakeholder activism should push for a well-founded investment policy, while at the same time investment performance evaluations should be based, not on short-term but on medium- to long-term returns, where the noise introduced by transitory market fluctuations are presumably smoothed out. The longer the performance evaluation period, the less likely is that performance is explained by exogenous factors (as opposed to management skills).

Some investment management public sector entities allocate part of their funds to external institutions for management (Box 8). External managers may have better skills or they may provide a higher level of safety. External managers can be valuable as a source of transfer of technology, advice and knowledge (training) and as basis for comparison (IMF, 2004). However, outsourcing of fund management would require issuance of terms of references consistent with the fund investment policy and strategy, and continue monitoring of their performance. Furthermore, outsourcing fund management will still maintain responsibilities on the fund governing body and fund managers for the fund performance.

Box 8: Outsourcing in the management of the Government Pension Fund Norway

"The Ministry of Finance and Folketrygdfondet have… entered into… (an)… agreement for the management of the Government Pension Fund – Norway...
… Folketrygdfondet is required to manage the Pension Fund in accordance with this agreement and within the framework established by … the laws, regulations, …for the management of the Pension Fund…
In the management of the Pension Fund, Folketrygdfondet may… use external managers and other external service providers (outsourcing)…
In the case of outsourcing, Folketrygdfondet maintains the full responsibility towards the Ministry of Finance for meeting… and has a duty to (ensure that):

- *…the internal control and the ability to monitor compliance with the obligations under this agreement are not impaired…;*
- *… the service provider has the necessary competence… and …licenses required to perform the tasks…;*
- *…the service provider supervises the outsourced functions and handles the risk associated with the task;…*
- *…at all times (it has)… procedures to… monitor the service provider,… and handle the risk associated with the outsourced activities;*
- *… (it takes)…measures if the service provider does not perform the task … satisfactorily;*
- *…the service provider notifies Folketrygdfondet of changes… that may… influence the service provider's possibility to perform its tasks;*
- *…the outsourcing contract can be terminated by Folketrygdfonde …;*
- *…Folketrygdfondet and the service provider have a contingency plan…;*
- *…Folketrygdfondet and the auditor have actual access to information related to the outsourced activity…;*
- *…the service provider treats confidential information relating to Folketrygdfondet in a satisfactory manner.*

The first time external managers and other external service providers… for the management of the Pension Fund are selected, the Ministry of Finance shall be informed of the process…, and of the remuneration model used in the management contracts that Folketrygdfondet signs with external managers…"

Source: http://www.ftf.no/en/c-309-Management-agreement.aspx

2.2 Prudent-Person Principles and Quantitative Restrictions

The investment policy should be primarily guided by a prudent-person standard. Quantitative restrictions may also be put in place as long as they do not inhibit the pursuit of the Fund's objective, or when the internal governance structure and/or the degree of transparency and accountability is deficient.

There are some guidelines to be considered when enforcing the prudent person principle in social security institutions: i) with internal investment units; ii) that have representation on the boards of companies where they have considerable asset holdings and iii) with external fund managers. In the first case, the investment unit must comply with the prudent person principle in managing the funds of the social security institution and carry out the investment policies set out by the Board/Management. The Board or Management determines whether the investment proposals have undergone due diligence and the valuation of the investment portfolio is in conformity with international market standards and pursues professional custody of the investment assets of the social security institution. For institutions with representation in Boards of Companies, the Board should ensure that its representatives on boards of companies only represent the interests of the institution. Regarding the institutions with External Fund Managers, the Board/Management must look forward that best practices are used when selecting the fund managers for the investment reserve funds of the social security institution and that the incentives of the external fund managers are lined up with the general investment objectives of the social security institution. In order to enhance accountability and transparency, the institution must guarantee the separation of the investment assets that are managed by the external fund managers from their own operating assets.

The regulatory and supervisory environment in many countries in practice is not so clear. Many pension funds with a prudent person rule have introduced quantitative limitations and many if not most PPFs have restrictions on overseas investments. The amount that can be invested abroad is a common restriction. The rationality of that is the fact that assets and liabilities are, in this way denominated in the same currency avoiding a costly hedging. A more profound motive is to limit the capital flows, whose volatility has been blamed for economic crisis in emerging countries. Finally, by limiting overseas investments, the argument follows; the policy is deepening domestic capital markets (Vittas, 1999). However, this approach may conflict with the overriding principle of maximizing the fund risk adjusted net return.

Under a prudent person standard, the governing body is given broad authority to invest the Fund’s assets, relying on its care, diligence and skill in selecting a portfolio consistent with the Fund’s goal. Quantitative restrictions, in turn, are set for prudential purposes to strengthen portfolio’s security and liquidity (see Box 9). However, there is a serious dilemma at play, as the prudent person approach cannot be implemented in the presence of highly restrictive investment guidelines. Provided the governing body displays the desirable degrees of professionalism, incentives, integrity, resources, and political independence, and that proper transparency and accountability prevail, the prudent person standard decidedly dominates the application of quantitative restrictions. The reason is simply that it is highly unlikely that rigid investment rules –which often are not supported by any sound prior technical portfolio analysis tailored to the particular pension scheme- might yield worse long-term financial outcomes than those obtained by apt fund managers. Nevertheless, if governance and outside monitoring are not satisfactory, an intermediate model where the governing body is subject to some investment limits may be a (hopefully temporary) second-best solution –the first best being a well-governed, accountable and transparent governing body.

To this end, the legal provisions of the Fund should set minimum, basic investment criteria. Hence, it should avoid, to the extent possible, establishing quantitative restrictions on particular investments or any other detailed rules which may inhibit the ability of the investing body to attain the Fund's goal and impair the flexibility to cope with unexpected, adverse market developments.

Quantitative restrictions typically take the form of maximum shares (ceilings) in various asset categories and markets. Minimum limits (floors) are unusual, and should be avoided because they may jeopardize the ability to close or reduce positions in assets with poor prospects. Overall ceilings by asset class (equity, corporate bonds, government debt, deposits, and foreign assets) should also be avoided, because they tend to erect inefficient barriers to portfolio diversification. On the contrary, some limitations may be acceptable to prevent an excessive concentration in a given sector, in an asset, in a single issue, or in a single issuer. Derivatives should be allowed for hedging but not for speculative purposes. Illiquid securities (either traded or not) may also be limited but not necessarily prohibited, as they may represent profitable options for funds with a long-term horizon. Eligible issuers should be required to observe acceptable governance and disclosure practices. As long as the nature of their business is similar, it would be desirable that PPFs are subject to similar investment regulations (and other regulations for that matter) to those affecting private pension funds and other institutional investors.

The adoption of high-quality accounting standards is a key element which facilitates the understanding and measures of the risks, the financial position on a consistent and comparable basis. In recent years a particular focus on IFRS (International Financial Reporting Standards) has been on standard principles. Valuation issues in these standards are related to the widely approach of "marking to market" that requires that securities held for ready sale are properly reported at their market value in financial statements. For assets that do not trade on organized exchanges like real estate, a transparent valuation model could be used. To minimize valuation problems, investment rules could prohibit or limit holdings (World Bank, 2000).

Box 9: Investment restrictions of the
Government Pension Fund Global of Norway

"The investment restrictions within this section apply to investments in equity and fixed income defined asset classes only.

- *The following limits apply to the maximum deviation between the actual portfolio and the benchmark portfolio: asset class 2.5 percentage points, geographical region 5 percentage points, sector deviation in the equity portfolio 5 percentage points, government bonds (Treasuries) no restriction, other sectors in the fixed income portfolio 20 percentage points.*
- *The overlap between actual portfolio and benchmark portfolio must be at least 60% for the equity portfolio and 40% for issuers in the fixed income portfolio.*
- *The actual portfolio must not over time utilize more than 75% of the risk limits set by the portfolio's owners under normal market conditions. The risk limit is 1.50 percentage points*

- *The issue of call options on individual securities that are not held in the actual portfolio is not permitted. Issuing of put and call options (measured as notional value) is limited to 2.5% of the portfolios' value.*
- *Leveraging the portfolio is not permitted beyond what is necessary to minimize transaction costs or is a natural part of normal investment management, and not in excess of 7.5% of the market value of the portfolio.*
- *Sale of securities that the portfolio does not own (short selling) may take place only in cases where NBIM has access to an established borrowing arrangement. Borrowing may not exceed 5% of the market value of the portfolio.*
- *Lending of securities is permitted, provided that NBIM ensures that adequate security is provided for the loan. Loans of securities shall not exceed 35% of the market value of the portfolio.*
- *It is not permitted to buy fixed income instruments with lower quality than investment grade for more than 1% of the market value of the Fixed Income part of the portfolio, and not more than 0.05 % of the market value of the Fixed Income part of the portfolio per single name.*
- *Norges Bank must always retain at least one voting share in each company included in the portfolio to ensure that ownership rights can be exercised".*

Source:http://www.norges-bank.no/upload/78329/nbim%20public%20investment%20mandate%20spu%20dec09.pdf

2.3 Benchmarking

The investment policy should determine benchmarks against which the Fund's financial performance should be measured.

A practical and carefully specified and documented benchmark index or financial target is the cornerstone of an effective accountability framework. It should be public, easily recognizable and understood by the scheme members. Let us recall that the goal of the benchmark is to provide all stakeholders with an external, observable, and objective yardstick that may be used to judge whether the governing body is doing a good job. Loose or obscure goals do nothing but to provide the governing body with arguments to shield itself from possible objections, and discourage the control exerted by trustees.

Benchmarks should be tailored to the specific nature and contractual obligations of the system and should be ineludibly consistent with the stated Fund's goal. Furthermore, the adequacy of the benchmark must be periodically reviewed. In light of the fact that both investment policies and benchmarks may vary over time in response to market changes, the legal framework should not specify a particular index to track nor should establish a particular benchmark-relative performance rule. The benchmark should play an ex ante performance incentive rule, by signaling the determination of the government and other stakeholders to keep a vigilant eye on the governing body and eventually terminate the contract with the appointment of new authorities if the mandated goal is not achieved (see Box 10). However, the failure to meet the target in any given period may or may not necessarily carry an automatic sanction, unless it conveys a robust indication of systematic underperformance or professional misconduct.

Box 10: Investment policy and benchmarks of the State Pension Fund of Finland

The State Pension Fund of Finland (VER) "is external to the State budget, VER having been established to guarantee the payment of State pensions in the future and to balance the costs arising from that…

The Fund's operations are governed by specific legislation. Moreover, the Fund has a Board of Directors appointed by the Ministry of Finance that decides on the Fund's investment principles and is responsible for its operations…

VER ensures that its investments are secure, deliver a high return, can be converted into cash, and are appropriately diversified…

Since no insolvency requirement is placed on the Fund, the characteristics of its investment operations are determined by the expected return and the choice of risk level. The return and profit targets set for the Fund in the operation guideline issued by the Ministry of Finance are as follows:

- *Long-term target return:*

In the long term, the State Pension Fund's investment activities must produce a higher return than an investment alternative that would be risk-free from the State's point of view. A risk-free alternative refers to the cost of the State's net debt, including the cost of derivative contracts made as part of debt management. Net debt refers to the difference between the State's budgeted debt and cash reserves.

- *Operational target return:*

The return on the State Pension Fund's investment activities, when adjusted for risk, must exceed the return of the reference index specified in the Fund's investment plan.

Neutral basic allocation:
The risk limits relative to the value of VER's investment portfolio set by the operation guideline issued on 13 November 2007 by the Ministry of Finance are as follows:

- *fixed-income investments must account for at least 45 per cent*
- *equity investments may not exceed 45 per cent*
- *other investments may not exceed 12 per cent*

VER's annual investment plan, approved by the Board of Directors, defines a neutral basic allocation for the investment portfolio, according to which investments are allocated for different investment categories. Here, the goal is to create a portfolio that yields the best possible return in the long run at the risk level set by the Board. Neutral basic allocation refers to an index-linked and feasible distribution of investments. It is continuously monitored and changed according to need. The neutral basic allocation guides investment operations in the long term".

Fixed-income portfolio benchmark indices:	Weight
Effas EMU Government	35.0%
Barcap EMU HICP Linked	15.0%
JP Morgan Cash Index	25.0%
Barcap Euro Aggregate ex Treasuries	25.0%

Equity portfolio benchmark indices:	Weight
OMX Helsinki Cap	21.0%
OMX Stockholm Benchmark Cap	9.0%
MSCI Europe	24.5%
MSCI Europe Value	10.5%
MSCI North America	15.0%
MSCI Japan	10.0%
MSCI AC Far East Free ex Japan	5.0%
MSCI Emerging Markets	5.0%

Source:http://www.statepensionfund.fi/public/download.aspx?ID=77802&GUID={A8DF4DC9-FE7E-44FF-8851-728E4ADCF28C}

Benchmarking, though, has some complications of its own. The downside of mandating to outperform, or at least not underperform, a given benchmark is that it immediately creates an incentive to track and replicate the benchmark index, which may not be the intended behavior. Moreover, with a peer-group index (i.e., not to underperform some industry average), the Fund may be compelled to mimic the portfolio of its competitors, in a so-called herding behavior that has been extensively studied in the context of private pension funds. Another problem is that the determination to beat the benchmark may induce the governing body to take excessive risks, which is not recommended at all.[9] Additionally, benchmarking may become particularly complex in DB schemes, once portfolio strategy may be concerned about not only the correlation structure of asset returns but also the correlation with the growth of pension liabilities. But regardless of these caveats, which are common to the whole institutional investment industry, depriving stakeholders from a quantitative yardstick would be quite troublesome when it comes to assessing governing body's performance.

Some simple benchmarks can be applied across the board: (i) calculation of real return, using the urban CPI; (ii) measurement of total real returns against real covered wage growth; and (iii) measurement of total real returns against the real rate of return on 91 days; and one, five, ten and twenty years treasury securities. Beyond that, each asset class likely needs to be measured against its own benchmark which then becomes very difficult to understand for the average member.

It must be noted that the relevance and disciplining role of the benchmark heightens when investment choices are made under the prudent person standard. Otherwise, bad performance may be blamed on either the governing body or on the investment regulation, thus blurring accountability.

[9] In DC systems with multiple funds, benchmarking presents some additional difficulties when each of these funds offers a combination of various asset classes with distinct risk and return profiles.

3. Transparency and Accountability

3.1 Disclosure and Reporting

The governing body should disclose all relevant information to all parties involved in a clear, accurate and timely fashion.

Without timely and complete information, the oversight bodies and the scheme members will have a low probability of detecting and penalizing wrongdoing.

There are different clienteles demanding information, and the governing body should accommodate the supply to satisfy such different needs, adapting the content and presentation to the particular audience. For instance, for most scheme members and beneficiaries, the provision of highly detailed and technical information may likely represent an overburden rather than facilitating monitoring. But this does not preclude that specialized parties, such as auditors, actuaries, and pension experts do require thorough analytical data.

It cannot be overstressed the importance of an easy-to-browse internet portal. Nowadays, this is the most widespread and less costly means of communication utilized by millions of people. Actually, hard copy reports, given their mailing costs and more limited outreach, are not a perfect substitute of an amiable and self-contained website.

Box 11 provides a minimum set of information that should be disclosed.

Box 11: List of Disclosure Requirements for Public Pension Funds

This box enumerates a series of specific data that, at a minimum, Funds should disclose to all scheme members and stakeholders. To start, some basic informational conditions to be met are:

- *Accuracy;*
- *Timeliness;*
- *Relevance (restricting the set of information to what the median stakeholder would require to make decisions);*
- *User friendliness (presenting information in a clear and straightforward fashion and avoiding excessively technical data as well as an ambiguous wording);*
- *Easiness of access (facilitating navigation through the website, and providing hard copies upon request); and*
- *Effective contact information (meaning that phone calls, electronic mails, and personal visits are actively taken care of).*
- *Grounded on these principles, the specific information set that should be disclosed includes the following:*

A. Legal Framework, Charters, and Bylaws

The legal support of the Fund must be readily available for consultation. This comprises:

- *The law of creation;*
- *The main subsequent resolutions;*
- *The charter and bylaws;*
- *A Code of Corporate Governance; and*
- *A Code of Director Conduct.*

B. Governing Body

- *Governance structure;*
- *Nomination and recruitment procedures for managers and directors;*
- *Independence and suitability of external managers and directors;*
- *Detection and treatment of conflicts of interest;*
- *Director tenure and term limits;*
- *External directors' compensation;*
- *Number, structure and membership of committees;*
- *Frequency of Board and Committee meetings;*
- *Board composition (number and integration by external experts, government officials and labor and employer representatives);*
- *Directors' voting and veto powers; and*
- *Causes of dismissal of managers and directors.*

C. Administrative and Legal Relationship of the Governing Body with National Government

- *Place and hierarchical status in the government organizational chart, or nature of the specialized organism (government-owned corporation, decentralized organism, private corporation);*
- *Effective degree of administrative and financial independence;*
- *Role of the government in appointing and dismissing Fund authorities;*
- *Role of the government in setting and modifying investment policies and strategies;*
- *Powers vested to the government to divert Fund assets to non-pension uses and to modify accumulation rules;*
- *Government obligations to contribute to the Fund on a regular or extraordinary basis.*

D. Investment Policy

- *Details on decision making process, and the role, if any, of the Investment Committee and of external advisory services;*
- *The short- and long-term goals and strategies, and their justification;*
- *The legal and normative investment limits;*
- *Bechmarking and performance evaluation; and*
- *The asset valuation principles.*

E. Oversight and Accountability

- *External audit report;*
- *Actuarial reviews, whenever applicable; and*
- *Reporting to the Executive and Legislative Powers.*

F. Disclosure

- *Quarterly and annual reports; and*
- *The Fund's website.*

Minimum contents, presented in comprehensible terms, should cover the following aspects:

- *Objectives and mandate of the Fund;*
- *Brief bio of senior management and Board members;*
- *Organizational chart;*
- *Staff number and professional profile;*
- *Fund assets;*
- *Itemized costs and revenues;*
- *Investment allocations by asset class;*
- *Investment returns, benchmarks, and performance evaluation;*
- *Contact information (phone, physical address, electronic mail);*
- *Member complaining and redressing mechanisms;*
- *Complete frequently asked questions (FAQ) section;*
- *Financial education section (benefits and risks of pension funds, calculators, consumer protection principles); and*
- *Links to related government offices, local and international organizations, and external information sources.*

Source: Bebczuck and Musalem (2008).

3.2 Relationship with the Executive

The Fund operations should focus on fulfilling its legal mandate and therefore should be subject to the least possible political interference. *Nevertheless, the independence of the Governing Body has to be counterbalanced with: (i) disclosure via periodic reporting; and (ii) supervision, to avoid corruption and illegitimacy*

In the case of private pension funds, the boundary between the fund manager and the public sector is well defined, with the former being overseen by the latter. Conversely, in PPFs, this boundary is blurred as a result of the dual role of the government as manager and regulator. The main prerequisite to keep political interference at arm's length is to put in place an internal governance structure along the lines suggested previously in this document (see Box 12 in Section 3.3). This mission will turn more challenging for funds whose governing body comprises government representatives, since these officials are unlikely to take an independent stand on issues that conflict with political aspirations. Under these circumstances, the offsetting presence of knowledgeable and honest governing body members recruited from the private sector becomes critical.

It is worth noting, nevertheless, that government involvement in the administration of the fund may not cause per se inefficient outcomes, nor the lack of direct involvement guarantees a truly independent ruling. The main concern with government interference is that it might force (i) a heavier investment in public debt beyond what would be wise for portfolio efficiency purposes, or (ii) a diversion of fund assets into fiscal non-pension operating expenses that may jeopardize the actuarial solvency of the Fund in

DB schemes or cause an illicit expropriation of individual accounts in DC systems.[10] These problems are much more likely to occur in bad economic times, when fiscal financing needs are more pressing. On the contrary, during periods of solid fiscal stances and soaring financial markets, the risks of government mismanagement are largely subdued. This asymmetry implies that the oversight bodies should maintain an active surveillance even when performance indicators do not signal immediate problems on the surface. When a negative shock finally hits the Fund, it might be too late to start revamping the governance structure.

As was just mentioned, another issue is that government interference may happen even under a fully private sector composition of the governing body, provided board members are appointed on the basis of political affiliation and have dubious professional and integrity standards. Close reliance on the governance principles previously outlined appears as the fundamental safeguard against direct or indirect state intrusion. Oversight bodies should of course exert an extreme vigilance on any warning signs of undue political interference, regardless of whether nominal independence exists in the law.

3.3 Relationship with the Legislature

The governing body should report to the Legislature on a regular basis as a means of establishing proper checks and balances against inappropriate political interference by the Executive.

The Legislative is vested with the power to establish the key policy directions of the Fund and making sure that the Executive abides by them. In performing this mission, the Legislative enjoys the advantage of a leveled position in terms of institutional rank vis-à-vis the Executive compared to other external oversight bodies, which is a crucial asset in countries where the latter lack effective enforcing power. Therefore, it makes sense that the Parliament, after analysis at the level of a commission, should be in charge of approving (or not) the annual statements of the Fund (see Box 12), have the right to summon the governing body members to testify, and require correcting measures when needed, including the dismissal of Fund authorities.

Regrettably, in fragile institutional settings, the Legislative rarely stands as a countervailing force to the Executive. The motives range from lack of technical competence or awareness about financial matters to the presence of a voting majority of the ruling political party.

The governing body should submit at least once a year annual report to the Congress with information regarding policy investment, composition and performance of the fund. In addition, monthly information about financial statements should be submitted to the appointed supervisor for the social security.

[10] If the law makes a nil or loose reference to this problem, it would be difficult for any internal or external body to veto political-based decisions. This suggests that the drafting of the legal framework should strike a balance between flexibility in the actual management of the Fund and some limitations aimed to restrict discretionality in the investment and use of the assets. These limitations should not be confused with providing strict investment ceilings and floors, which should be avoided by all means.

Box 12: Independence of the governing body of the New Zealand Superannuation Fund

The New Zealand Superannuation Fund "is governed by a separate Crown entity called the Guardians of New Zealand Superannuation.

The entity is overseen by a Board. Its members are appointed by the Governor General on the recommendation of the Minister of Finance. The Minister's recommendation follows nominations from an independent nominating committee. On receiving those nominations the Minister must consult with representatives of other political parties in Parliament before recommending the Governor General appoint a person to the Board.

Board members are chosen for their experience, training, and expertise in the management of financial investments.

The Board must comprise of at least five, but no more than seven, members. Each Board member is appointed for a term of up to five years and is eligible to be reappointed…

…While accountable to Government, the Guardians operate at arm's length from Government. Under the law, the Minister of Finance may give directions to the Guardians regarding the Government's expectations as to the Fund's performance, but must not give any direction that is inconsistent with the duty to invest the Fund on a prudent, commercial basis. The Guardians must have regard to any direction from the Minister. Any direction given by the Minister must be tabled in Parliament. The New Zealand Superannuation and Retirement Income Act 2001 and the Crown Entities Act 2004, both published on the website of the Parliamentary Counsel office, provide more information on the role and responsibility of the Minister.

…An independent review of how effectively and efficiently the Guardians are performing their function is carried out every five years. The first review was conducted in July 2004.

The Minister of Finance sets the terms of reference for the review, which is conducted by an independent person appointed by the Minister. The report is then presented to Parliament. Treasury monitors the activities of the Guardians on an ongoing basis on behalf of the Government.

In 2008 the Guardians' Governance and Management of the Fund was subject to a review by the Office of the Auditor General."

Source: http://www.nzsuperfund.co.nz/index.asp?pageID=2145879271#independence-from-government

3.4 Relationship with plan members

Plan members and beneficiaries should be provided with all relevant information for making, if applicable, fully informed choices.

Current and future retired workers are undoubtedly the chief beneficiaries of a sensible fund management policy. Being that the case, the correct incentives are in place for these beneficiaries to exert the necessary vigilance over the governing body (See Box 13). However, in practice, this control can be only partial in view of: (i) The long-term nature of retirement saving, which discourages monitoring in the presence of myopia, high time preference or extreme economic uncertainty; (ii) The perception of retirement contributions as a tax in countries with a history of pension asset expropriation; (iii) The expectation that the State will take care of pension payments regardless of the financial situation of the system; (iv) The well-known informational asymmetries suffered by the bulk of beneficiaries, which might cloud the full understanding of the underlying financial operation. High fixed monitoring costs and free riding compound the problem; and (v) In the case of mandatory PPFs, if a decisive disciplining mechanism (the competition among funds and the ability of plan members to "vote with their feet") is not available, seriously constraining the incentive to monitor.[11]

It is clear that DC regimes offer a more propitious environment for scheme member activism because of the full correspondence between contributions and benefits through individual accounts. On the contrary, the collective ownership characterizing DB arrangements lessens the incentive to scrutinize fund operations. But in a case or the other, a good internal governance and oversight structure are needed to make up for the incomplete disciplining from the direct beneficiaries. This does not downplay the need to keep scheme members and beneficiaries fully and clearly informed about their accounts and the working of the system as a whole: first, many of them still have the incentives and financial skills to put this information to good use; and second, market discipline may gradually improve over time by means of well-designed financial literacy programs and easier access to information (internet use is a good example).

The set of information to plan members and beneficiaries must include at minimum a quarterly statement or secure individual internet access on: (i) total contributions received in all previous years; (ii) detailed contributions received on a monthly basis per year; (iii) applicable wage base (month by month); (iv) rate of return for individual's portfolio if applicable (DC schemes); (v) account balance if applicable (DC schemes) (vi) projected benefit at the retirement age based on explicitly indicated assumptions.

Box 13: Public access to information in the Future Fund of Australia

Section 8 of the Freedom of Information Act 1982 (FOI Act) requires the Future Fund Management Agency to publish detailed information about how it is organized and what decision making powers it has, what arrangements it makes for public involvement in its work, what types of documents it holds, and how the public can obtain access to these documents...

…Categories of documents held by the Agency:

[11] Several of these obstacles to market discipline apply to a large extent to other financial intermediaries.

- *Representations to portfolio ministers: the Agency holds representations made to the Treasurer and the Minister for Finance and Administration on matters relating to the operation of the Agency and related investment policies.*
- *Working files: the Agency holds files dealing with policy and administration in the investment of funds in accordance with the Investment Mandate and investment policies issued by the Board. The documents on these files include internal and externally-provided investment advice, correspondence, analysis and policy advice by Agency officers and drafts of these and other documents.*
- *Documents on internal departmental administration: Agency documents relating to staff and departmental organisation and operation include personal records, organisation and staffing records, financial and expenditure records, and internal operations such as office procedures and instructions.*

…The Agency's primary published document is its Annual Report which is available on the Agency's website as well as in the printed version. In accordance with the Future Fund Act, the Investment Mandate and investment policies are to be published on the Agency's website.
…If a member of the public requests a document and access is approved, the Agency will provide copies of documents after the applicant pays any charges.

Source:http://www.futurefund.gov.au/__data/assets/pdf_file/0020/965/FutureFundAnnualReport_v5.pdf

3.5 Redress

Scheme members and beneficiaries should be granted prompt statutory redress mechanisms through a layered approach – grievance procedures and redress policies handled through administrative means; redress to an ombudsman, redress through an arbitration body established for arbitrating disputes which cannot be resolved administratively for this purpose; and, as a last resort, through the courts.

Current and future beneficiaries of the scheme should have the opportunity to challenge decisions and actions that unduly harm their personal interest. Given the mandatory and non-competitive nature of PPFs, this consumer protection service is particularly indispensable. Put another way, there cannot be any incentive to monitor unless a fair compensation is set in advance upon detection of member rights being violated (See Box 14).

Box 14: Redress in the National Insurance Fund of Jamaica

In the National Insurance Fund of Jamaica web states that "If you are dissatisfied with the services you have received you should inform us by using our easily accessible complains system for prompt an effective response.

- *Use our suggestion books if you think the problem is not very urgent*
- *If the problem must be handled expeditiously, ask to see a supervisor*
- *All complaints will be investigated and a reply sent to you within two weeks of receipt of the complaint*
- *Corrective measures to complaints will be taken for example*
  - *Apologies to customers*
  - *Removal/resolution of possible cause(s) of complaints*
- *If you are not satisfied with the manner in which your complaints was dealt with you may contact the:*
  The Permanent Secretary, 1F North Street, Kingston
- *If you are still dissatisfied with the handling of a complaint, an appeal may be directed to:*
  The Manager, Standards and Monitoring Unit,
  Citizen's Charter Section, 2a Devon Road, Kingston 6
- *For further redress, complaints can also be directed to:*
  The Parliamentary Ombudsman, 78 Harbour Street, Kingston"

Source: *http://www.mlss.gov.jm/pub/index.php?artid=74*

Redress usually involves : (i) contributions not recorded or not properly deposited by the employer; (ii) disagreements over benefit calculations; (iii) delayed or withheld disbursements; (iv) failure of the staff of the managing agency to abide by the operational policies set out, including service standards; and (v) requiring service fees not specified in the law.

Less straightforward are the following implementation aspects:

(i) *The range of acts for which redress is appropriate*. Individuals may file claims for actions or decisions taken in bad faith, such as negligence or dishonesty in providing timely, accurate and relevant disclosure on account balances, investment returns, administrative costs, and other items (including contributions and benefits, if under the jurisdiction of the governing body), as well as in relation to undue charges. Inadequate personal service or any sort of discriminatory treatment should also be a legitimate reason for complaint. As a general principle, complaints lodged with respect to issues affecting all members or retirees should be collectively redressed and not compensated on an individual basis, but instead should be assessed by the corresponding oversight bodies. To streamline the process, individual complaint and redress channels should only be open for individual cases (as opposed to claims affecting the whole universe of the scheme members); and

(ii) *The structure of the consumer protection service*. An independent office within the organizational structure of the Fund should be vested with the power to handle and resolve these matters following a written and publicly available procedure. If unsatisfied with the outcome, the complainant should have the right to an expedite and free-of-charge investigation and satisfactory resolution (including a written explanation), and also to refer the matter to a financial service ombudsman or the ordinary courts (depending of the judicial system in place). The internal office of the Fund should maintain and disclose its records about the number, nature and resolution of complaints, and the governing body and external oversight bodies should periodically evaluate its performance.

3.6 Regulation and Supervision

The Fund should be under the specific regulation and supervision of the organism for the social security and other public pension schemes. It could also be subject to the oversight of a particular financial intermediary supervisory authority.

Most countries' Social Security schemes are subject to a separate regulatory authority and subject to a separate supervisory authority although there is a potential conflict of interest in having the State as its own regulator and the supervisor may have little incentive to carry out its mandate

To avoid that and while at the international level this is not a common practice,[12] PPFs should be subject to conventional regulation for at least three reasons: (i) the nature of their activity is fully compatible to that of private pension funds, which are under strict regulation worldwide. What is more, PPFs are prone to severe management failures that may be too costly to society; (ii) public sector-owned banks, another financial intermediary with the same ownership and incentive problems as PPFs, are under regulation in a number of countries; and (iii) a single PPF could be the dominant force in the domestic financial market. To avoid this, the fund could be separated among a range of fund managers[13] (see Box 15) or put management processes under mandatory supervision by a third-party entity; either specialized entities or financial market supervisors, such as central bank, insurance or security market supervisor (see Box 8 in Section 2.1).

[12] The list of countries that implement supervision of public pension funds is growing slowly. This practice has been in place since recently in countries such as Colombia, Costa Rica, India, and Morocco.
[13] Carmichael and Palacios (2004).

Box 15: National Pension Funds of Sweden have no market dominance

Sweden has five National Pension Funds:

- *First National Pension Fund (AP1),*
- *Second National Pension Fund (AP2),*
- *Third National Pension Fund (AP3),*
- *Fourth National Pension Fund (AP4)*
- *Sixth National Pension Fund (AP6).*

According to Musalem and Souto's Transparency and Governance Index (TGI) these PPF are between the funds with the highest scores of their sample. AP1 and AP4 are in the third and fourth position, respectively. Not far below are the rest. The assets of these PPFs represented 30% of the GDP in 2007. Each of the first four PPFs reached about one fourth of the total assets. While AP6, bound by law to invest in venture capital of small and medium size firms, only represents 0,6% of the GDP.

Source: Musalem and Souto (2009).

Despite its potential benefits, it must be borne in mind that the effectiveness of this surveillance will depend on the particular institutional setting of the country and the personal qualities of the regulator appointed. Therefore, it is not advisable to concentrate the full oversight activity on the regulator, but instead keep a plural oversight structure, both internal and external.

3.7 External Audit

The Fund's accounting statements must be certified by an external auditor with credentials according to those specified by law. The audited statements should be disclosed along with all observations the external auditor might have made.

Many PPFs, civil service schemes, and military and police are audited by the Auditor General by law (see Box 16). As a complement, first-rate external auditors are equipped with the correct incentives to carry out an independent evaluation of the Fund. Firms in this market operate in a very competitive environment (despite a small number of players) in which reputation is a major asset. In addition, their multinational structure makes them less permeable to political interference. Of course, from theory and evidence, these contractual arrangements are not fully free from conflicts of interest, but the above conditions tend to minimize their likelihood relative to other oversight bodies because of the associated costs of opportunistic behavior. Musalem and Souto (2009) found that over the 83 PPFs they analyzed, 38 were audited by external auditors and 11 by their internal or state audit unit, while for 7 no report was found although there was an indication of the existence of an audit in the web. For the 33% of the PPF there was no information regarding the issue.

Box 16: Independent Auditor's Report
of the National Pension Service of South Korea

To Minister of the Health, Welfare, and Family Affairs and the National Pension Fund Management Committee:

February 6, 2009

We have audited the accompanying balance sheet of the National Pension Service as of December 31, 2008 and December 31, 2007, and the related statements of income, retained earnings, and cash flow for the same said years ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We audited in accordance with auditing standards generally accepted in the Republic of Korea... An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation...

In our opinion, the financial statements referred to above present fair, in all material respects, the financial position of the National Pension Service as of December 31, 2008 and December 31, 2007, and the results of its operations and its cash flows for the same years ended are in conformity with the National Pension Act, the Enforcement Decree of the National Pension Act, Generally Accepted Accounting Principles, fund accounting regulations, and the accounting principles accepted in the Republic of Korea…

Sung Bok Yoon
Samjong KPMG Group CEO

Source: 2008 Annual Report on Pension Fund Management, http://www.nps.or.kr/jsppage/english/npf_korea/npf_06_01.jsp

3.8 Effective Accountability

The governing body should be accountable to plan members and the competent authorities. Furthermore, the legal framework, the statute and the by-laws of the Fund should clearly state the criteria used to judge the performance of the governing body and the penalties applicable.

Accountability means that the governing body should be liable for its actions and omissions with a view to the best interest of scheme members (see Box 17). In practice, however, accountability is extremely difficult to be made operational. The main benefit of an effective accountability framework is not the cost borne ex post by the manager in case of failure but the ex ante incentive to perform well so as to avoid any future penalty. For this to be a credible threat in the eyes of the governing body, the following conditions should be met: (i) All stakeholders should have access to the relevant information for judging performance; and (ii) The criteria upon which the governing body may be held liable, as well as the resulting penalties, should be unambiguously specified in the legal and normative framework, and subsequently enforced.

Box 17: Accountability of the
National Insurance Fund of Trinidad and Tobago

The National Insurance Fund of Trinidad and Tobago "is an organisation that honours its obligation to properly and effectively serve its stakeholders and manage a significant and growing public fund. As such, embedded in our legislation, policies and procedures are practices that promote good governance, accountability and ethical behaviour. Further, the tripartite composition of our Board of Directors ensures that all stakeholders are represented at the various levels of authority. From staff to managers and our various Board Committees, we practice strict adherence to disciplined and exacting processes that promote consistency, fairness, accountability and transparency in our operations.
The timely submission of our annual reports, including audited financial statements, for each of our 36 years of existence and more recently the publication of these reports is cogent testimony of the value we place on accountability to the people of Trinidad and Tobago.
We recognize that this is one of our key traits that builds public confidence and are constantly on our guard to ensure that this trust is not shaken. To this end, during the last year we have reviewed and tightened our procedures and processes with respect to insurance administration, tendering, resolution of audit queries and promoting information security".

http://www.nibtt.co.tt/2009/NIB%20Annual%20Report%202%202%2009.pdf

One major obstacle, common to the whole fund management industry, is the difficulty to screen good from bad managers, which in turn is explained by the difficulty to accurately measure inputs and outputs. On practical grounds, it is convenient first to separate dishonesty from incompetence. Dishonest acts are those committed deliberately by abusing the powers of office to reap personal rents at the expense of the pension scheme. Examples are the use of the position in the governing body to secure a contract with a related party at non-market values, conducting illicit financial transactions using the Fund's technical or financial resources, and other forms of self-dealing. Incompetence, on the other hand, refers to the failure to act with due skill, care, and diligence, reflecting on abnormally low gross returns, excessive risk-taking, or high operating costs. While the uncovering of a self-dealing transaction can be objectively documented, incompetence is more intricate to prove, since bad outcomes can arise from either ineptitude or negligence on the part of the fund manager or from exogenous factors such as market downturns or cost inflation. The use of financial benchmarks may be complemented with cost benchmarks (for example, other institutional investors of similar size and business profile).

Some caution should be exerted in evaluating and punishing misbehavior. In particular, attention should be called on the following: (i) Negative performance reviews should not be based purely on absolute returns or on a short time span. Oversight bodies should instead penalize consistently bad relative performance measured over a long period (say, at least 3 years), except for extraordinarily deficient outcomes calling for urgent intervention; (ii) Penalties for self-dealing should be harsher than for incompetence. Incompetence should lead to dismissal (or voluntary resignation) of the governing body members liable for the defective outcome, while both contract termination and penal actions should apply on self-dealing; and (iii) In self-dealing accusations brought to the courts, defendant governing body members should be provided official legal protection to cover the costs of litigation regardless of whether it is in or out of office. Only when bad faith is proved beyond reasonable doubt by the judiciary, the Fund may require full reimbursement of all expenses. This clause is intended to assure that the governing body is equipped with adequate incentives to pursue its goal of maximizing risk-adjusted net returns.

In schemes where there exists limited personal liability of governing body members, effective dismissal powers, and lack of independent oversight bodies, public accountability based on reputational costs matters significantly. That could be alleviated by the introduction of codes of conduct, personal disclosure requirements of material interest, and recusal procedures where conflicts of interest may apply. Hiring highly respected market players to occupy seats in the governing body is of utmost importance.

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