

A Framework for Public Pension Fund Management

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1. Introduction

Public pension schemes (or social security schemes as they are known in some countries) have long been recognized as having major economic and social implications. In addition to their obvious social welfare objective of providing adequate retirement incomes for the aged, public pension schemes can influence economic performance and capital accumulation through their effect on taxes and intergenerational transfers. For many countries, the implicit liability to fund public pensions is by far the most significant unrecognized liability in their public accounts.

Whereas the debate over public pensions in the 1970s and 1980s was predominantly about whether or not such schemes should be funded, the debate in the 1990s shifted to how best to organize the funding. In view of the acceptance of the importance of funding and the adoption by many countries of a funding program, it is appropriate that the focus should now shift to how public pension funds should be managed. This issue is largely about governance, broadly defined. While there is no one universal set of governance principles that will apply in every case, there are many principles that should have wide application. This paper outlines a framework for considering these issues.

Section 2 provides an overview of the growth of public sector pension funds throughout the world and the extent of funding. Section 3 summarizes the general principles of public sector governance and their application to public pension funds. Section 4 focuses on accountability issues. Section 5 discusses investment policies and Section 6 provides a brief concluding statement.

2. The Growth of Public Sector Pension Funds

Pension provision in most countries is a combination of public (unfunded) schemes, publicly-mandated contributory schemes and voluntary private retirement savings. In some countries, publicly-mandated pension contributions are privately managed, whereas in others the government has retained management of these funds either directly, or through a specially-created management agency. For the purposes of this paper we will treat both public unfunded schemes and publicly-managed mandatory schemes as equivalent. In both cases the government retains responsibility for the provision of retirement incomes from the scheme¹. The lines of distinction are nonetheless quite

¹ Possibly the best known of the publicly-managed mandatory schemes are those operated by Asian countries such as Singapore and Malaysia. Australia, in contrast, runs an unfunded public pension scheme that is unlinked to wages during employment, and a privately-managed mandatory contributory scheme.

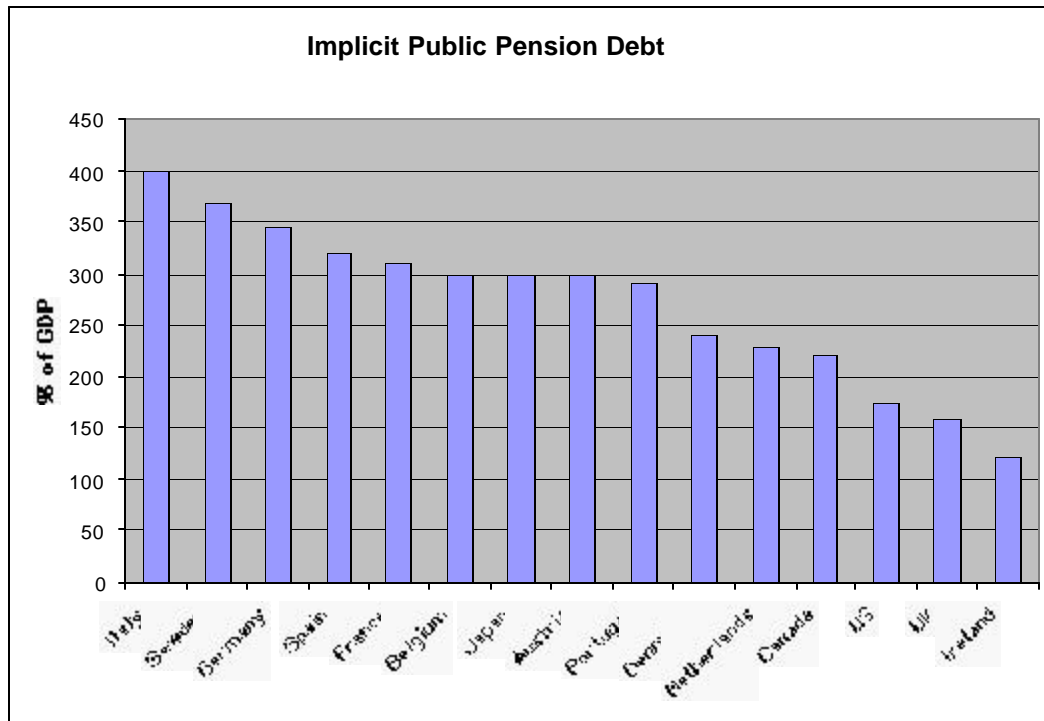
blurred since some privately-managed mandatory schemes carry explicit or implicit government guarantees and/or operate under government rules that are, in practical terms, tantamount to government management.

Given the widely-held belief that providing for the retired generation is primarily a responsibility of governments, it is not surprising that public pension schemes have by far the longest history of the different forms of retirement incomes provision. Initially, many of these schemes intended substantial prefunding of their obligations. In the post-war period however, there was increased acceptance of pay-as-you-go financing and little concern expressed over poor rates of return on pension fund investments. It has only been in recent decades, as populations have aged and the liabilities of public pension schemes have exploded, that many governments have shifted the focus of their attention to private pensions, both voluntary and publicly-mandated, as a means of reducing their future liabilities and mitigating increasingly obvious intergenerational transfers.

There is no international standard for reporting this liability, sometimes referred to as the implicit pension debt. This is an important point since, as discussed below, stating the extent to which accumulated reserves should cover the liability is one way of introducing discipline to the process. Despite the lack of consistent reporting, there have been several attempts to provide preliminary estimates across a range of countries.

Figure 1 below shows the unfunded liabilities of public schemes as a percentage of GDP for selected Organisation for Economic Co-operation and Development (OECD) countries as at 1994. In this case, the estimates are calculated by taking the net present value of expenditures between 1994 and 2070 using a five percent discount rate. The figure shows that implicit pension debt is typically much larger than the level of government debt on issue and larger than private pension assets – even in countries such as the United States which have well-developed and actively encouraged private sector pension schemes.

Figure 1: Implicit Public Pension Debt in Selected OECD Countries, 1994



Source: OECD (1996)

Another cross-country study by Holzmann et. al. (2003) reports the implicit pension debt for low and middle income countries. In this case, a concept similar to a projected benefit obligation is calculated using the World Bank PROST model.² Table 1 shows a huge range of magnitudes for the Implicit Pension Debt (IPD) with the former Soviet republics and Eastern European countries having the largest IPDs – more than 150 percent of GDP. Demographically younger countries with low coverage like El Salvador and Senegal and countries with relatively immature schemes such as Korea, have IPDs below 50 percent of GDP.³ It should be noted however, that these are still very high, especially when compared with the tax base that will have to finance the liabilities.

² Pension Reform Options Simulation Toolkit.

³ The Korean scheme began to operate only in 1988 and liabilities are growing rapidly as the first cohort to spend its entire active life in the system reaches retirement age.

Table 1: Implicit Public Pension Debt – Low and Middle Income Countries

Country	Public debt 1999/2000	Pension Spending	IPD by discount rate		
			2%	4%	5%
as share of GDP					
Brazil	33	9	500	330	275
Macedonia	41	9	441	291	244
Slovenia	25	11	429	298	255
Romania	18	6	386	256	214
Poland	43	12	379	261	220
Ukraine	59	9	365	257	220
Portugal	55	5	358	233	193
Malta	56	5	356	234	194
Slovakia	31	8	304	210	179
Hungary	59	9	300	203	171
Uruguay	45	14	295	214	187
Kyrgyz Rep.	135	7	282	185	154
Croatia	33	11	274	201	175
Estonia	7	9	268	189	163
Moldova	78	8	229	159	136
Lithuania	28	7	221	155	134
Nicaragua	109	2	220	131	104
Turkey	65	5	217	146	123
Costa Rica	34	2	203	121	97
Philippines	71	1	185	107	81
Iran	10	2	146	89	72
Bolivia	56	4	111	73	62
Argentina	53	5	106	85	78
Ecuador	209	1	103	63	51
Mexico	19	1	101	65	54
Colombia	24	2	88	56	46
Dominican Rep.	23	1	80	49	40
Cape Verde	52	1	78	47	38
Chile	9	7	77	60	53
Senegal	78	2	73	51	44
Mauritius	35	3	63	47	42
El Salvador	22	2	60	43	37
Peru	43	2	57	40	34
Korea	33	1	57	33	26
Morocco	79	1	50	32	26

Sources: Own calculations and public debt data based on SAVEM tables (World Bank), At-a-glance tables prepared for the Annual Meetings (World Bank), and various IMF statistics on Article IV consultations.

Many of these countries have engaged in an explicit policy of accumulating reserves to offset part of these liabilities. In many cases, a scaled premium approach has been used in order to smooth contribution rates over time and mitigate intergenerational transfers. In other cases, the reserves serve only as a buffer fund, aimed at avoiding short-term shocks due to changes in the revenue stream. Palacios (2002) estimates that across the world, at least 65 countries have significant reserves in their publicly-managed, defined

benefit schemes. Table 2 below shows the regional distribution of these funds. Together these assets represent approximately one quarter of global GDP⁴. They are often the single largest institutional investor in the country.

Table 2: Regional Distribution of Public Pension Funds

	Number of public funds	Percentage of countries in region	Average share of GDP
High income OECD	10	45%	10.8%
Latin America	11	44%	8.4%
Sub-Saharan Africa	22	47%	8.7%
East Asia	5	56%	7.0%
South Asia	9	90%	16.6%
Middle East/North Africa	7	33%	12.3%

Source: Palacios (2002).

The fact is however, that public pension reserves represent only a fraction of liabilities both individually and in the aggregate. This key ratio will be affected by pension reform trends that are now being observed around the world. First, after a long period of expansion, many countries are cutting benefit promises by a series of parametric reforms that redefine the defined benefit promise. The result is a reduction in the size of the IPD in many countries. Second, after decades of poor performance and a perception that pension reserves may have led to increased government consumption rather than increased public savings, a handful of countries are attempting to increase investment returns and ensure that real savings are being generated. Finally, a few countries, such as China, are beginning to build up significant public pension reserves in anticipation of a rapid ageing process.

The desire to increase the ratio of assets to liabilities in public pension funds has a parallel in the emergence of mandatory fully-funded plans in some countries and one is often presented as a substitute for the other. Whether achieving a certain funding ratio through the accumulation of reserves in a public or quasi-public scheme is feasible depends on the interlinked matters of governance, investment policy and accountability. Whereas strict actuarial rules and regulations often cover the funding arrangements and management of private sector defined benefits pension schemes, typically no such rules apply to governments. Whereas accountability of private sector plans is exerted through competition under the rules applied by a supervisory agency in most countries, this is difficult in the public monopoly context. It is also appears more difficult to separate investment policy of the public pension fund from other government objectives when a large pool of public pension fund assets are involved. This paper is an attempt to frame an approach these difficult questions.

⁴ It should be noted however, that three quarters of total global assets are those in the partially funded plans of Japan and the United States.

3. Governance of Public Pension Schemes

Governance of public pension schemes is a specific application of the more general subject of public sector governance.

The literature on public sector governance is relatively new. That corporate governance has been the main focus of attention in recent years is hardly surprising in view of the spectacular corporate collapses of companies the size of Enron and WorldCom. The lower profile of public sector governance arises from the fact that poor governance in the public sector is more likely to lead to slower growth, economic inefficiency and corruption, than to spectacular collapses. The costs of poor public sector governance, however, are at least as great as those of poor corporate governance; indeed they are arguably much greater.

This section looks first at the general issues raised by public sector governance, then applies the relevant principles to public pension management.

3.1 Public Sector Governance – General Issues

There is no universally-agreed definition of public sector governance. Nor is there a straightforward translation from the definitions of corporate governance to the public sector⁵. Most of the definitions of corporate governance are oriented towards shareholders and are therefore not strictly appropriate in the public sector context. For that reason we suggest the following working definition for the purposes of this paper – one that is flexible enough to cover both public and private sector governance:

Governance refers to the systems and processes by which a company or government manages its affairs with the objective of maximizing the welfare of and resolving the conflicts of interest among its stakeholders.

Defined in this way, governance includes issues such as transparency, resolution of conflicts and the overall way in which the business in question is run.

As noted by Carmichael (2002) the need for high standards of public sector governance arises from the same types of issues that give rise to the need for strong corporate governance. Namely, in acting on behalf of its citizens, the government creates a principal/agent problem for its citizens. The difficulty in resolving the public sector principal/agent problem is that, in most instances, there is no ready metric by which the agents can measure the performance of the principals. However, provided there is adequate transparency for the scheme, this should be much less of a problem in the case of public pension schemes than it is in areas such as regulation, public policy or law enforcement.

⁵ See, for example, the definitions given by the OECD (1999 p.2 and 2001 p.1).

A second difficulty in resolving the principal/agent problem where government is involved is the hiatus between elections. Unlike corporate shareholders, citizens are effectively disenfranchised from their political vote between elections. Again, this should be less important in the case of public pension schemes than in other areas of public policy and management, provided there is adequate transparency and accountability.

Carmichael suggests that government involvement in the financial sector is particularly prone to conflicts of interest and therefore in need of special attention from a governance perspective. These conflicts arise from the government's extensive participation in the financial systems:

- as the regulator of financial institutions;
- as an owner of financial institutions;
- as a market participant;
- as a fiduciary agent; and
- through direct intervention in the operations of the market.

To address these conflicts, Carmichael suggests a set of principles for public sector governance. These principles, which draw on and expand the IMF Code of Good Practices on Transparency in Fiscal and the Code of Practices on Transparency in Monetary and Financial Policies, cover the following four main areas:

- transparency and accountability;
- independence and accountability of financial regulatory agencies;
- effectiveness of financial regulatory agencies; and
- anti-corruption measures.

Of these four areas, only the first and the fourth are particularly relevant for public pension schemes. Anti-corruption and good management issues are expanded in the context of public pension schemes in the following sub-section. Accountability and transparency issues are addressed separately in the next section.

3.2 Laying a Foundation for Public Pension Scheme Governance

Before examining the governance measures that may be appropriate for different public pension schemes it is necessary to identify the risks to stakeholders from public involvement.

Stakeholder risks fall into 3 main categories:

- failure of the government to meet its retirement incomes promises;
- use (or misuse) of contributors' funds by the government to meet its social policy objectives (other than its retirement incomes objectives);
- underperformance of the fund due to the use of contributors' funds for directed lending or as a captive source of finance for the government; and
- loss of funds due to corruption or mismanagement.

Not all of these risks apply equally to every form of public pension scheme. For example, unfunded schemes are exposed primarily to the first risk. The major risk in an unfunded public pension scheme is that the government's retirement incomes promises grow beyond the budget's capacity to fund them – usually as a result of demographic changes such as an increase in longevity, a reduction in fertility or a reduction in the taxpayer base.

The ease with which governments can change the terms of the scheme is partly a function of the precision of the promises made by the scheme and partly a function of the legal tradition involved. Where the pension scheme is unlinked to earnings during employment, governments have mostly found it relatively easy (legally though not always politically) to effect a reduction in the scheme's liabilities by either reducing benefits or by tightening eligibility requirements. Where the promise is more explicit, adjusting the scheme has been less straightforward. In the United States, for example, the courts have ruled that the terms of the scheme can be changed by the government at its discretion. On the other hand, the courts have ruled against certain changes in several European countries⁶.

The risk that a government will fail to deliver against its promises is more explicit in government managed mandatory contribution schemes. While funded public defined benefits schemes are usually guaranteed by the government for underperformance due to theft or misuse of contributors' funds, the ultimate guarantors are the taxpayers themselves⁷. With taxpayers as the ultimate guarantors, there is a distinct temptation for some governments to use those funds for political and even personal purposes. The temptation is increased by the fact that the timing of the payoff to members of the funds is usually far removed in time (which means the unpalatable increase in tax rates will be the responsibility of a future government), whereas the benefits from exploiting the available resources are usually available immediately.

The existence of contributors' funds also introduces the risk of misuse of funds, underperformance due to directed lending and mismanagement. The existence of a

⁶ For example, in Croatia, parametric changes involving the indexation of pensions in progress were rejected by the courts resulting in a large liability related to retroactive pension payments. See Anusic et. al. (2003).

⁷ Although the taxpayers forced to fund deficiencies may well be future generations.

government guarantee does not entirely remove the risk of promissory failure. Indonesia is a good example of the risks involved. The Indonesian Government mandates Indonesian workers to contribute to the publicly-managed fund JAMSOSTEK. Following a period in which previous Governments often directed the allocation of contributed funds to favored projects and uses there are serious concerns about the adequacy of the fund to meet its promises. While the full extent of the funding gap is unclear, there is a widespread perception among Indonesians that they are at risk given the severe budgetary constraints under which the Indonesian Government operates.

The primary defenses against each of these risks are good governance structures and transparency (see next section). The governance provisions of public pension schemes should be aimed at establishing good business practices, avoiding corruption, avoiding mismanagement and avoiding abuses by the government itself.

Drawing partly on the IMF Codes of Good Practices on Fiscal, Monetary and Financial Policies we suggest the following as a starting point or foundation set of best practice principles for the governance of publicly-managed pension schemes⁸.

a) There should be clarity of roles and responsibilities within the pension fund.

Clarity of roles, objectives and responsibilities is fundamental to transparency (and to accountability).

The objectives should be set down by government – preferably in law - along with an explicit statement about the promises being made, and any government guarantees involved.

The objectives and responsibilities of the agency established to manage the scheme should also be stated clearly – again preferably in law – and made available to the public.

b) The law establishing the management agency should provide unambiguous conditions under which members of the governing body of the agency can be appointed and removed.

Some public pension schemes are managed within the government, effectively as departments, while others are managed by specially established agencies. In some countries these agencies operate as statutory authorities, while in others they operate as trusts. In general, we regard the departmental model as too open to abuse and therefore below best practice. Whatever the precise legal form, the members of the governing body of the management agencies operate with a fiduciary responsibility

⁸ The IMF practices are set out in much greater detail in the Code of Good Practices on Fiscal Transparency and Code of Good Practices on Transparency in Monetary and Financial Policies. Both are available on the IMF's website at <http://www.imf.org/external/standards/index.htm>.

to the members of the scheme, and that single consideration should dictate the appropriate appointment and dismissal terms.

While independence of directors/trustees from the government is important in some respects (see below), it is less critical than in the case of a regulatory agency. The more critical requirement is that directors/trustees act honestly, diligently and effectively in the interests of members. Thus, a fit and proper person test for appointment is likely to form the centerpiece of appointment conditions. The test should include explicit prohibitions, such as persons with a criminal record, as well as general skill requirements. Directors/trustees should operate under strict rules to minimize conflicts of interest. Penalties for the abuse of their positions as directors/trustees should be harsh.

The practice in some countries of appointing representative boards rather than professional boards, while admirable in intent, is unlikely to provide the level of expertise and commitment needed for good governance.⁹ Nevertheless, where this tradition is strong, there may be ways of mitigating problems including training of trustees or the creation of independent advisory committees made up of professionals.

Dismissal provisions need to strike a balance between the need to remove a director or trustee quickly where breaches of fiduciary responsibilities are in question, and the need to prevent arbitrary dismissal, for example where the trustees resist improper attempts by the government to use the fund in ways that are explicitly prohibited by the terms of the scheme. Natural justice considerations suggest that, where a director/trustee has been accused of any impropriety, he/she should stand aside from the management agency while the matter is dealt with.

Unlike some other public sector agencies, where independence requires a higher level of protection from dismissal, the directors/trustees of a public pension scheme should be able to be dismissed if their performance is not up to the standard required by the fund's objectives, provided the assessment of performance is not arbitrary. For example, poor strategic decisions that result in consistent underperformance of benchmarks over a period of years should be adequate grounds for replacing directors/trustees. Of course, this can only happen if information on performance is reliable and available in a timely fashion (see accountability section).

c) The managing agency should be free from inappropriate interference from the government in pursuing its objectives and meeting its responsibilities.

Ideally, the government should remain at arm's length from the investment decisions of the fund manager. In the event that government wishes to retain the right to direct

⁹ Most countries use representative boards while only three are known to use purely professional boards as discussed in Palacios (2002). See the paper by Hess and Impavido for this conference for additional detail regarding board size and composition and other governance practices in a sample of developing country public pension funds.

lending to particular sectors or activities (including financing its own budget deficits) it should do so openly and transparently. Best practice suggests that the law establishing the scheme should identify what is “inappropriate interference” and the directors/trustees should be protected from dismissal for resisting inappropriate interference (see above).

d) The processes for formulating and executing scheme policies should be open and transparent.

The policy framework, and its process of implementation should be disclosed and adequately explained. The different roles of the government and the managing agency in establishing and executing policy should be clearly distinguished.

e) The government should establish the structure of delegations permitted within the scheme.

For example, if the manager of the scheme is established as a statutory agency, the law establishing the agency should spell out the powers of the governing Board of the agency as well as the powers of delegation within the agency. Where delegation to external operators is contemplated, this should be explicitly permitted by law and, where appropriate, circumscribed. For example, the law may permit outsourcing of IT and back office functions but not of investment decisions; it may permit internal delegation of operational decisions but not of strategic decisions; and so on. The essential point is that the structure of delegations should be well thought out and transparent to stakeholders. The structure of delegations should state clearly where responsibility lies in the event of delegation. Responsibility should include the explicit requirement for the governing body of the management agency to monitor and review delegated powers.

f) The management agency should be required – by law – to establish internal governance structures and processes designed to minimize corruption, mismanagement and fraud.

These governance procedures should include the mandatory establishment of a risk management and audit committee with appropriate reporting lines. It should include a Code of Conduct for staff and senior executives, detailing how to deal with conflicts of interest and establishing minimum standards of ethical behaviour (including protection for whistleblowers). It should detail the roles and responsibilities of the different groups within the agency (board, senior management, audit committee, etc) and how they are to account for their actions. It should include a quality control process and it should include rigorous documentation, review and audit requirements on investment decisions and IT support systems. Many of the best practice governance requirements that have been developed for investment companies, including the requirement to establish a compliance committee, are applicable to public pension fund management agencies.

g) The government should require the management agency to be regulated and supervised by the same agency that is responsible for regulating private pension providers and, where feasible, to meet the same standards imposed on private providers.

Not only is this requirement a matter of good governance, it is compatible with the objective of establishing competitive neutrality throughout the financial system. Nevertheless, there may be limited divergences in prudential standards. The most obvious of these is the minimum funding regulations typically imposed on the private sector. Given the role of the Government as the implicit guarantor of the public scheme, and also the explicit partial funding nature of many public schemes, requiring the public scheme to meet the same minimum funding requirements as private pension schemes is somewhat redundant¹⁰. The same principle applies to the minimum capital requirements often imposed on private sector managers. Public pension schemes should, however, be expected to comply with the same governance, accountability and investment rules as their private sector counterparts.

These governance requirements are not onerous in any sense other than restricting the scope for the government and the scheme managers from using the funds to their own advantage under the cover of opacity.

The establishment in 2000 of the Irish National Pensions Reserve Fund provides a good example of many of the governance requirements outlined above¹¹. The National Pensions Reserve Fund Act 2000, provides for:

- the statutory obligation for the Irish Government to pay the equivalent of 1 per cent of GNP into the Fund each year until at least 2055;
- the establishment of an independent Commission, the National Pensions Reserve Fund Commission, to control and manage the Fund, with discretionary authority to determine and implement an investment strategy for the Fund, based on commercial principles;
- the appointment of seven Commissioners by the Minister for Finance, subject to a statutory requirement for substantive expertise at a senior level in specified areas;
- appointment of the National Treasury Management Agency as manager of the Fund to carry out such functions as are delegated to it for this purpose by the Commission – the appointment of the Agency is for a period of 10 years, with five-yearly options to extend or to appoint an alternative manager;
- a strictly commercial investment mandate for the Fund with the objective of securing the optimal return over the long-term subject to prudent risk management (the Fund is explicitly prohibited from investing in Irish Government

¹⁰ Even in this case however, parallel regulations defining the level of partial funding could be applied.

¹¹ See Anne Maher's (2003) paper prepared for this conference.

securities, to ensure that the Fund is not used to artificially support Government borrowing); and

- appointment by the Commission of investment managers to invest and manage portions of the Fund and custodians to ensure the safekeeping and security of the assets of the Fund.

3.3 A Governance Checklist

The following is a set of questions designed to assist countries to assess the extent to which their public pension schemes meet the intent of the best practice governance guidelines proposed above.

- Are the roles of the respective parties in the public pension scheme clear – for example, is the government’s promise clear, are the objectives of the managing agency clearly and publicly enunciated, and so on?
- Are the terms under which the managing agency and its governing members appointed and terminated well understood?
- Are there adequate fit and proper person protections to prevent the agency from being deliberately manipulated by the government or the Board of the agency?
- Is the management agency open and transparent about its governance structures?
- Is the scheme open to periodic review; do the government and/or the managing agency welcome constructive criticism?
- How well does the agency’s internal and/or external governance systems compare with those imposed by the regulator of private pensions?

4. Accountability of Public Sector Pension Schemes

Good governance is essentially about establishing structures to ensure that a business is well run. Accountability is about ensuring that the governance structures are effective by creating compatible incentives. That said, there are many issues that exist in the grey area between governance and accountability. In the framework proposed in this paper we have attempted, as much as possible, to identify under governance the structures that, according to best practice, should be in place while, under accountability, we have focused on the disclosures and incentives that should be associated with the implementation of those structures.

Compatible incentives are established when those who make decisions and business judgments are held responsible for them. Responsibility in this sense should not be restricted to the negative sense of the term – accountability should include rewards for exercising good judgment as well as penalties for poor judgments.

Since (most) governments are ultimately accountable through the electoral system, the focus of this section is on the accountability of the management agency to scheme members.

4.1 Laying a Foundation for Public Pension Scheme Accountability

The central considerations for a best practice accountability framework are transparency and reward structures.

The main role of transparency in the case of unfunded schemes is to reveal to taxpayers the likelihood of their being able to be funded at a suitable level from the government's budget. This requires either explicit recognition of the pension liability in the government's accounts or periodic disclosure by the government of trends in longevity, retirement incomes and the implications for budgetary pressures in coming years. An example of such a disclosure is the analysis published by the Australian Government in its 2003 budget papers projecting the impact of trends in longevity and fertility on public pensions and, through them, on forward budgets¹².

In the case of contributory schemes, transparency requirements should go well beyond budgetary projections (which provide information about the financial strength of the guarantor but not about the financial strength of the fund). The ultimate safeguard for pension investors in these cases is full disclosure of portfolio composition, investment decisions and performance. Many funds are reluctant to disclose such information on the grounds of competitive disadvantage. While this reluctance is understandable, the risk to both the investors and the guarantor are such that disclosure should dominate market sensitivities. Releasing detailed portfolio statistics with an appropriate lag can reduce the competitive disadvantage involved.

With these considerations in mind we suggest the following as a starting point for an accountability framework for public pension schemes.

- a. There should be full and open disclosure about the governance structure of the scheme and the managing agency.*

Some elements of the governance structure are likely, as a matter of course, to be disclosed in the law establishing the agency. Other governance features are more likely to be implemented as a result of the governance requirements imposed on the agency by the law (for example, the requirement to establish an explicit structure of delegations). Accountability requires that details about the governance structure are made public. In particular, there should be adequate disclosure of arrangements put in place to detect and prevent fraud.

¹² See Australian Government (2003). In this review, the Australian Government found that the combined impact of these factors was minimal for around 15 years, after which it generated a growing fiscal gap that reached 2% by 25 years and 4% by 35 years.

An example of the issues that might be covered in such a public governance document is included in Attachment B. This attachment outlines the index of the governance document put together by the Board of the Australian Prudential Regulation Authority (APRA). While APRA is regulatory agency rather than a pension management agency, the governance issues are very similar.

b) As part of its disclosure of governance arrangements the managing agency should be required to publish its formal delegations of powers and responsibilities.

Delegations are central to accountability. In the case of funded public pension schemes the contributors to the scheme (the principals) delegate the management and safety of their investments to the Government appointed scheme managers (the agents). The managers in turn delegate certain decisions to various individuals within the agency. For example, the managers may employ specialist funds managers, back office processors, account managers and so on. In some cases, some of these functions are outsourced to private firms. These delegations should be made publicly available and should be reviewed regularly.

Once the agency has formalized its structure of delegations it should make these available to all stakeholders (for example, through its web site).

c) Funding shortfalls should be identified and disclosed, along with the government's proposed remedial actions.

The process for assessing and dealing with a funding shortfall should be transparent - and preferably contained in law. The fund should be subject to periodic actuarial review and, unless the government has an explicit policy of partial funding, the government should be required to fund any actuarial shortfall that it has guaranteed, as happens in many countries with private sector defined benefits schemes. Where the government has an explicit policy of partial funding, the extent of the underfunding should still be assessed and reported in the government's accounts.

Where the scheme is unfunded, there should be periodic actuarial assessment of pension liabilities under a range of scenarios for longevity and fertility. Ideally, where this assessment indicates a future problem, the government should identify a strategy to deal with it.

d) The management agency should be subject to regular governance and performance audit.

The agency should be subject to regular audit by an independent and credible external auditor for its performance. In addition, there should be a periodic review of the governance procedures and their effectiveness within the agency. The findings of the audits should be open to public scrutiny, at least in summary form.

- e) *The management agency should be required to report comprehensively on its decisions and performance.*

To avoid undue market disadvantage, detailed could be done annually and with an acceptable lag. The reporting, however, should provide adequate information for full scrutiny of the agency's performance. The report should include a detailed breakdown of asset composition by investment type and sector on at least a quarterly basis. It should provide a full disclosure of fees paid and earned. It should provide full details of the cost of operations, including comparisons with industry benchmarks. It should include a break-down of performance against a predetermined and public set of benchmarks. Quarterly summary reports should be reported on overall performance, with an attribution analysis. If these reports are to be useful, best practice international accounting standards for valuation of assets, calculation of returns and other figures must be adopted. At a minimum, the accounting standards for the public pension fund should not be less rigorous than those applied to private pensions in the same country.

Where governments explicitly direct investments for social purposes (not our preferred model but one which cannot be ruled out for obvious political reasons) the impact of these decisions should be calculated separately and disclosed to members.

- f) *To the greatest extent possible, rewards for performance should be linked to delegated responsibilities and should be risk based.*

Those who make delegated decisions should be rewarded or sanctioned according to the way in which they exercise their delegations. Contracts should not be written that create the potential for expensive exits of staff or service providers who have failed to meet the expectations of their positions or contracts.

Since the primary purpose of a pension fund is to provide income replacement in retirement, the performance of the fund is central to meeting this objective. As discussed in the next section, performance involves a balance between risk and return. A feature of best practice financial incentive structures is that they offer performance rewards for returns adjusted for risk. Put simply, a 10% return earned from lending to governments is not the same as a 10% return earned in trading derivative products. The financial markets convention in calculating performance is to measure either risk-adjusted return per dollar of capital or assets committed or unadjusted returns per dollar of risk-adjusted capital or assets committed. Either is acceptable as a basis for calculating rewards.

- g) *Managers should be required to review periodically (e.g. monthly) the exercise of delegations they have made*

In making delegations, the managers should provide guidance as to how the delegated powers are to be exercised. For example, delegation of investment powers in certain securities may be accompanied by explicit restrictions on the types of securities that the funds may be invested in, as well as a risk limit (such as an overall Value at Risk

limit). E.g., by way of maximum and minimum portfolio shares or Value at risk limits. The accountability reports should record the actual investment decisions made, the consequences of those decisions, as well as any breaches of the guidelines.

Effort should be made to encourage a compliance culture within the agency. Compliance should be rewarded, while breaches of guidelines (either governance guidelines or investment guidelines) should be penalized – even where higher than expected returns are earned.

4.2 An Accountability Checklist

The following is a set of questions designed to assist countries to assess the extent to which their public pension schemes meet the intent of the best practice accountability guidelines proposed above. While some of the issues covered may be requirements of law, a well governed-agency could be expected to provide much of this information voluntarily as a matter of good practice.

- Does the public have access to adequate information about the governance structures of the public pensions scheme and its managing agency, either through explicit laws, annual reports, publications and/or web sites?
- Is disclosure of potential conflicts of interest of Board members required and imposed?
- Is the scheme subject to regular independent audit for both governance and performance?
- Are the financial performance and financial state of the scheme revealed publicly on a regular basis based on sound accounting standards?
- Is the scheme's financial performance reported against established benchmarks?
- Is the government open about its liabilities under the scheme and subject to independent actuarial reviews?
- Are the incentive structures within the scheme transparent to the public, linked to delegated responsibilities and risk based?

5. Investment Policies

As funding of public pension schemes increases worldwide, governments are increasingly finding themselves in the role of fiduciary agents for their citizens. This role carries with it an implied responsibility for the public pension manager to select an investment strategy that balances risk and return appropriately for the citizens on whose behalf it is investing.

The investment policy involves three main components: setting long-run performance targets; defining an acceptable risk tolerance; and setting parameters for short-term asset allocation. In addition, procedures to be followed with regard to the implementation of the investment policy must be clearly defined.¹³ The long-run targets and selection of a tolerance for risk involve strategic decisions. These strategic decisions are fundamental to the viability of the scheme as a source of income replacement in retirement. The long-run strategies should identify whether the risk tolerance and performance targets are capable of producing outcomes that will meet the objectives of the scheme. This part of the investment policy should establish the broad shape of the portfolio and the risk parameters, which will govern investment decisions. The strategic part of the policy should also establish the Board's position on non-financial issues such as shareholder activism, socially-responsible investments and/or economically targeted investments.

In the case of a private sector investment fund the primary focus of investment policy is on the balancing of market risks and returns. These risks include the risk of loss due to counterparty default (such as the bankruptcy of an issuer of debt or equity), the risk of loss due to movements in market prices (such as falls in equity prices, property prices, interest rates and/or exchange rates), and the risk of loss due to operational failure (such as a failure of IT systems, settlement procedures or legal documentation). The case of a public pension fund is more complex. In addition to these private sector risks, public pension funds must also contend with the potential for them to dominate markets, and the temptation for governments to direct the investments of the funds for their own purposes (including not only the temptation to use the fund to finance the government's own deficit, but also the temptation to provide credit directly to members for social reasons).

In the private finance sector, the market risk dimension of investment strategies is increasingly being expressed in terms of comprehensive measures of risk, such as Value-at-Risk, rather than in terms of prohibitions, sectoral limitations or target ratios. While diversification is often an explicit consideration in public sector investment policies, the modern approach of using a comprehensive measure of risk automatically incorporates diversification. This approach has yet to reach far into the public sector, where investments are often handicapped by limited mandates and restrictions that militate against modern risk management practices¹⁴. These issues, as well as the specific public sector risk issues need to be addressed as openly as possible.

¹³ Attachment A provides one example of a general investment policy statement by one of the largest public pension funds in the world, the ABP in Holland.

¹⁴ The one area in which prohibitions or restrictions may play a positive role is with respect to investing the government's own securities. See, for example, Maher (2003) for details of the Irish public pension fund's prohibition of investment in Irish Government securities.

5.1 Laying a Foundation for Public Pension Scheme Investment Policy and Process

- a) The central considerations for a best practice framework for investment policies are that they be transparent and clearly designed to operate in the best interests of fund members. With these in mind we suggest the following as a guide to best practice in the design and implementation of investment policies and processes for public pension funds. *The investment policy should state that the purpose of accumulating and investing pension reserves is solely for the benefit of members of the pension plan.*

Few public funds state this explicitly in practice¹⁵; in fact, many include other objectives such as economic development or advancing social welfare considerations in their mission statements.¹⁶ While these objectives are laudable, and while there may be positive indirect effects arising from the accumulation of long-term savings in the economy, giving them equivalent status with the interests of members inevitably leads to conflicting objectives.

The policy should make a clear statement about the investment of fund assets in government securities. While some funds expressly prohibit investment in government securities¹⁷, they may in many instances be viewed as an integral part of a balanced portfolio on both safety and liquidity grounds. An alternative to prohibition is to set limits on such investments to prevent their being improperly tapped as a source of funding at the government's initiative. Like all such limits they should not be regarded as immutable. However, the limits should be changed only by an explicit decision of the governing board of the fund and should be announced publicly, along with the reasons for making the change.

Similar considerations apply to lending from the fund back to members. This practice raises difficult issues. The first issue involves risk diversification. If public pension funds are to provide income replacement in retirement they should ideally be exposed to a diversified set of risks that are as different as possible to those facing members during their working lives. For the same reasons that many countries prohibit private pension funds from lending back to sponsor firms, there is a case for prohibiting the investing of pension fund assets back with members. This issue is by no means unambiguous since investment with members may enable them to better survive and prosper to retirement. Following this line of argument, some countries have encouraged their public pension funds to lend to members for housing¹⁸.

¹⁵ Two examples are Ireland and New Zealand as discussed in Maher (2003) and McCulloch (2003), respectively.

¹⁶ See Iglesias and Palacios (2000) and Hess and Impavido (2003).

¹⁷ For example, as noted earlier (Maher 2003), the Irish Public Pension Scheme imposes such a prohibition.

¹⁸ Singapore, for example, has instituted such a policy.

A more difficult issue involves equity among members. If a fund has a policy of lending to members it must establish unambiguous and non-discriminatory rules defining which members may borrow from the fund (that is, the qualifying criteria for access to the fund) and the terms under which such borrowing will take place. This type of lending increases the potential for corruption. An even more difficult issue involves how to handle defaults. If one member borrows from the fund and defaults, the burden of the default may result in a lower payout to other members or a greater tax burden to make up the shortfall if the government guarantees the benefits of the scheme. The alternative of assigning the loss from default against the benefits of the individual member involved would resolve the equity issue but would run contrary to the intent of the public pension scheme of providing a secure source of income in retirement.

Ultimately, lending to members by a public pension fund is little different to directed lending by government and should be avoided if possible. Where it is contemplated, the role of such lending should be clearly stated in the investment policy, along with how it fits the risk-return profile and objectives of the fund. The policy should also have transparent rules as to how applications for such lending will be evaluated and the terms on which it will be made available.

A policy that is directed solely to the interests of fund members will be characterized by few, if any, prohibitions on investments. The interests of fund members will be enhanced by sound diversification of risks. Rules that limit or prohibit investments (including investments in foreign securities) will reduce the capacity of the fund to diversify and serve the interests of fund members. The one area of exception to this general rule is that of lending to related parties (either to the government or to members) noted above. While some related party lending may be desirable in principle, this must be balanced against the potential for abuse and discrimination.

The policy statement should identify the potential for the fund to be or to become a dominant force in the domestic market and how it intends to resolve such situations. Since dominance can be negative for both the market and the members most countries have responded to the problem by establishing an explicit policy of dividing the portfolio into parts and outsourcing some of these to professional managers. The external managers are usually given clear guidelines as to the range of investments they may make and also of the risk-return profile they are to establish. Beyond that, (and the necessary performance monitoring) they are given minimal direction. This enables the external managers to compete with each other and to reduce the dominance of the fund in any particular market or security.

A final aspect of investment policy that should be addressed by the governing board is its attitude to exercising its voting rights as a shareholder. Since the fund could potentially be a major shareholder (especially in small markets) it has a responsibility to exercise its governance rights wisely. One way of minimizing the conflicts of interest that may arise from such situations is for the fund to publish, with a lag, a summary of the way in which it voted in its various shareholder capacities. Some countries, fearing that the potential for pressure on the public fund to influence

corporate governance for purposes other than those in the interest of the fund itself have imposed concentration limits or delegated voting rights to fund managers. The significance of this problem and the potential remedies are directly related to the relative size of the public pension fund relative to the markets in which it invests. In all cases however, a policy for shareholder voice should be explicit and documented.

- b) *The investment policy should be set by the Board of directors or trustees, should be fully documented and available in summary form to members of the scheme.*¹⁹

For obvious competitive reasons the publicly disclosed elements of the investment policy should be restricted to the broad strategic direction of the fund, the attitude towards risk and the Board's position on non-financial aspects of investment. It should not include details of strategies with respect to individual sectors or investments. The investment strategy should be clearly identified with the objectives of the scheme. It should be free of political direction (see above).

A key objective is the target funding ratio during a given time period. Many public, partially-funded, defined benefit schemes set this target in terms of the ratio of reserves to annual spending. Instead, the ratio of funds accumulated to liabilities should be the anchor for investment policy and the basis for setting a target long-term rate of return.²⁰

- c) *The investment policy should identify all relevant risks and the Board's approach to measuring, monitoring and managing each of them.*

While market risk is the predominant risk in any public pension portfolio, it is by no means the only source of risk. Like any investment fund, pension investments are subject to credit risk, liquidity risk and operational risk. The investment policy should identify each of these, how each potentially affects the performance of the fund in meeting the objectives of the scheme and how the Board proposes managing them.

For example, every public pension fund is unavoidably exposed to credit risk through its investments in fixed-interest securities and through counterparty exposures. The Board should ensure that the agency has a system for assessing credit risk and for managing exposures. Market price risk falls into the same category of unavoidable risks for public pension funds. These include interest rate risk and currency risk in particular. The investment policy should make a clear statement about the role of these risks and how they will be managed. Modern market practices should be adopted where they are relevant and appropriate.

¹⁹ See the paper by John Illkiw prepared for this conference with regard to strategic decisions on asset class allocation.

²⁰ For example, the CPPIB states its funding ratio target explicitly and its target real rate of return is consistent with this objective.

Liquidity risk is a particular problem for pension funds. One source of liquidity risk arises in meeting the income entitlements of retirees. The Board should ensure that the agency has a comprehensive system for measuring and monitoring the cash flows into and out of the fund, for projecting these forward and for ensuring that the fund has access to assured sources of liquidity at lowest cost. In this respect public pension funds should meet the same liquidity standards as are applied to private pension funds. Illiquidity also arises from investments in non-marketable assets. Not only do these investments reduce the liquidity of the fund they create accountability difficulties from their valuation. Without a ready market for revaluation of these assets, losses can accumulate undetected over long periods of time. At a minimum, public pension funds should require annual valuations from independent valuers of all their non-marketable investments. Ideally, a conservative adjustment factor should then be applied to reflect the difficulty and timeframe that may be involved in realising such a position. The collateral “haircuts” recommended by the draft Basel II framework for bank regulation provides a useful starting point for such an approach. At a minimum, the details of the valuation process and its results should be disclosed publicly.

- d) *The investment policy should clearly delineate the role of managers and the criteria for selection and retention of external parties where this is relevant. These criteria should be based on objective benchmarks that are provided regularly to the Board in a form that can be understood.*

As discussed in the paper by Ilkiw for this conference (Part IV), objective criteria are required to avoid conflicts over the retention of managers, especially when Board members do not have adequate financial expertise to assess performance.

5.2 An Investment Policy Checklist

The following is a set of questions designed to assist countries to assess the extent to which their public pension schemes meet the intent of the best practice investment policy guidelines proposed above.

- Is the investment policy fully documented and publicly available?
- Is the stated purpose of the scheme to benefit the members of the scheme and, if not, are there potential conflicts between stated objectives?
- Does the policy permit lending to government and/or members and, if so, are there transparent guidelines identifying the issues involved and governing how such investments will take place?
- Is the target rate of return based on a long-term funding ratio objective and is it consistent with this objective?
- Does the investment policy identify how it will deal with actual or potential market dominance?

- Have all major risks been identified and taken into consideration in forming the investment policy? Has the tolerable level of risk been defined by the Board.
- Are the processes involved in delegating the implementation of the investment policy to managers clearly defined? Are benchmark criteria for hiring and firing managers clear and the information needed by the Board to act on them available?
- Are the investment parameters defined in terms of restrictions and prohibitions or in terms of modern portfolio concepts?

6. Concluding Comments

This paper has attempted to draw together a set of principles which collectively define what we regard as best practice for establishing and operating a public pension scheme. The driving principles behind this framework are that the scheme should have clear objectives, be free from conflicts of interest, be operated in as transparent a manner as possible and that the operators of the scheme should be accountable to its members for their decisions and for the extent to which they have met or failed to meet the objectives of the scheme. In short, public pension schemes should be operated in the best interests of those who bear the tax burden of funding their financial failings.

In defining these principles as best practice we are fully aware that the pension schemes in many countries do not satisfy the principles we have outlined. In many cases, the deviations from best practice are deliberate and are designed to meet other objectives of governments. While we recognise the difficulty of affecting change in these situations, it is only through open discussion and public recognition of the issues involved that the members of public pension schemes can bring pressure on governments to change these schemes to better reflect their interests. Public debate about the extent of underfunding crisis in public pension schemes in the 1980s and 1990s encouraged many countries to begin funding. Hopefully, public debate now about the way in which this funding is managed will help avoid a different type of crisis in public pension funding in coming decades.

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Attachment A

ABP Investment Policy Statement

Attachment B

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Appendix A - Statutory responsibilities of Board members:

- Commonwealth Authorities and Companies Act 1997
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Appendix B – Matrix of Delegations:

- Treasurer's Delegations
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