

Managing Public Pension Funds: a Framework

Jeffrey Carmichael

APRA

And Robert Palacios

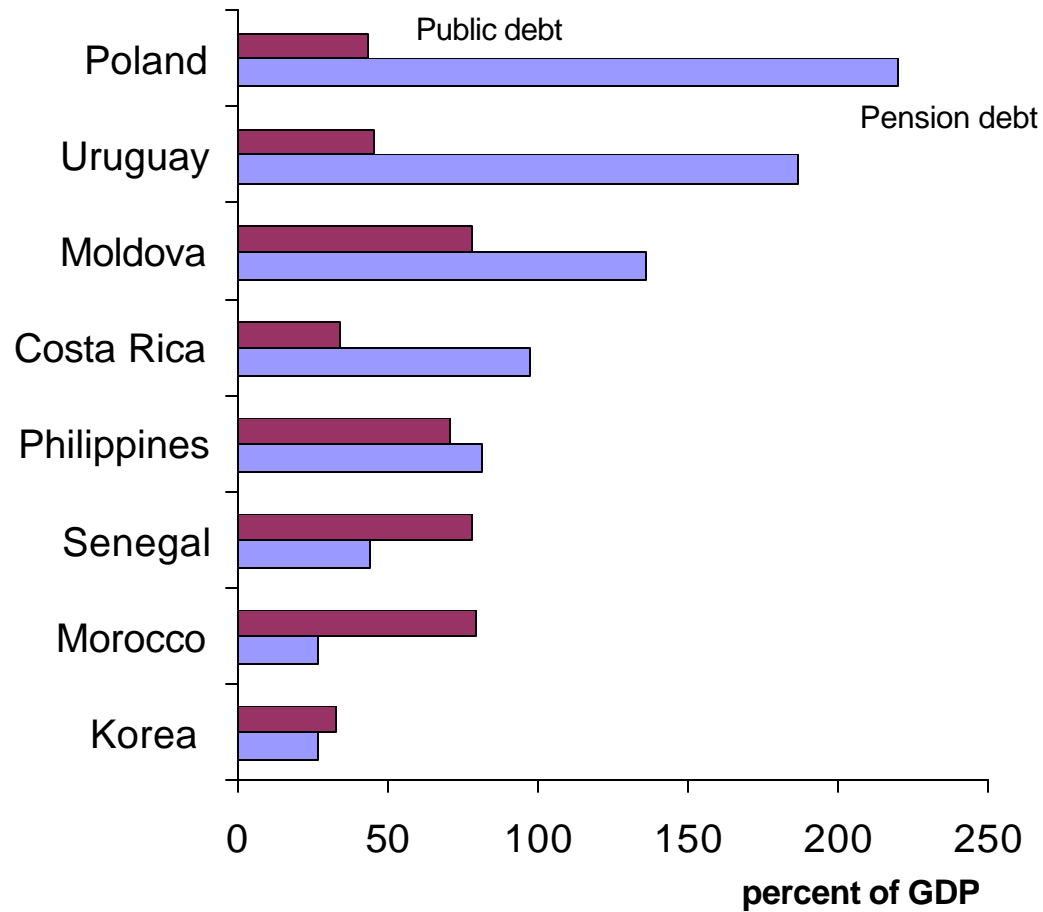
World Bank

May 2003

Outline of Session

- Background on public pension fund growth, structures and issues
- Issues to be considered in a Public Pension Fund Framework:
 - Governance of fund
 - Accountability of fund managers
 - Investment policies and processes
- Focus is on identifying the key issues and best practice principles

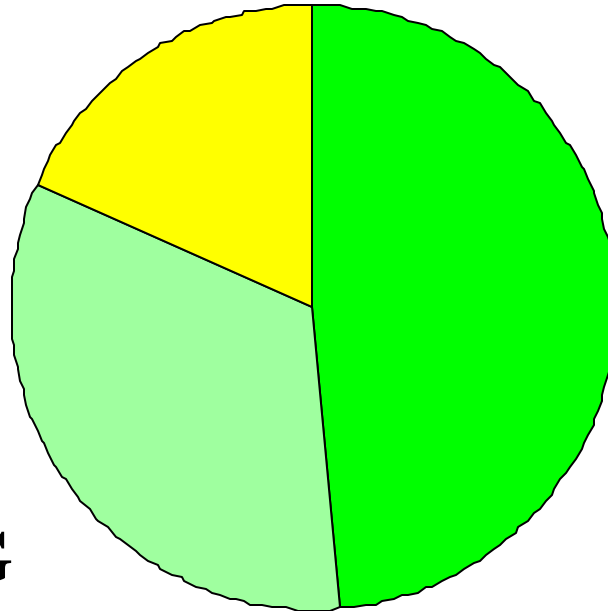
Recognizing public pension debt



Global funding patterns

MIXED FF AND PAYGO

**PARTIAL
FUNDING**

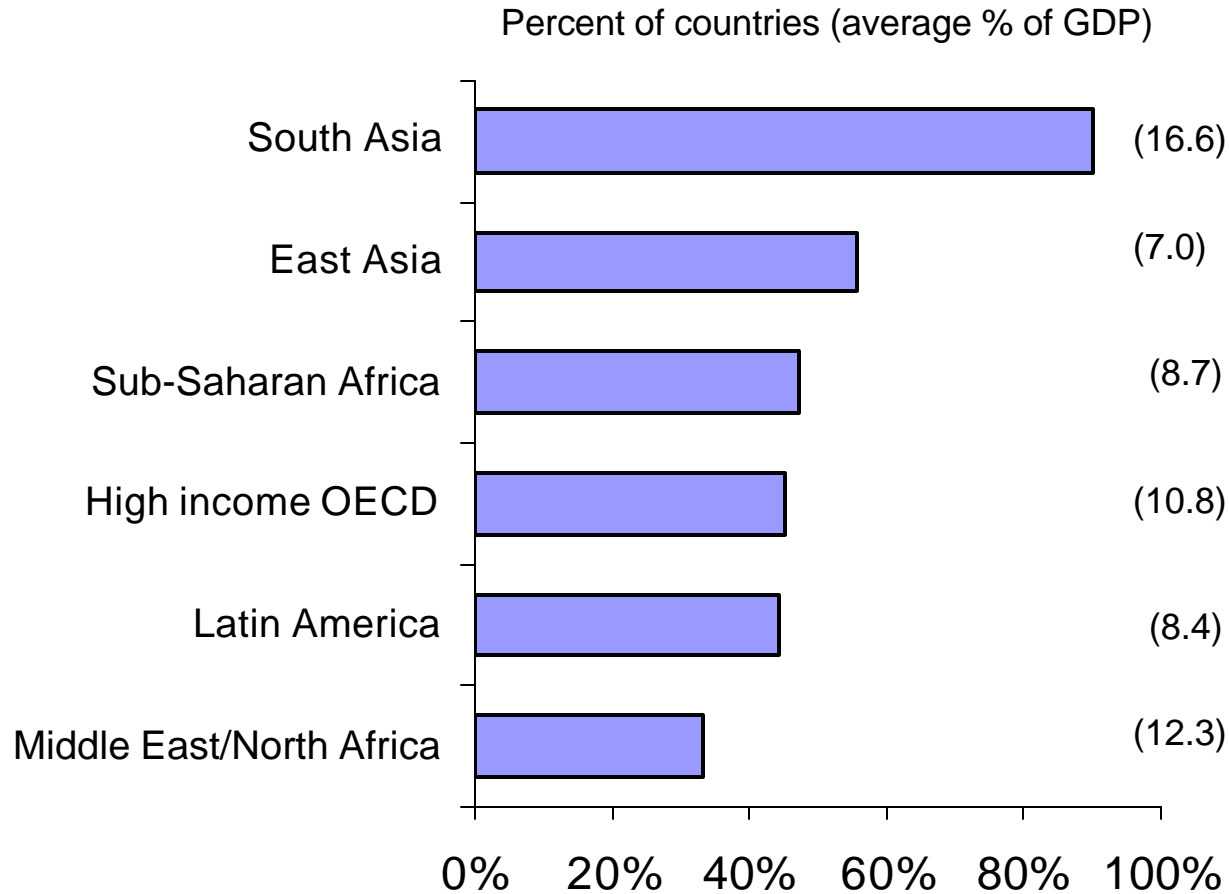


PAYGO

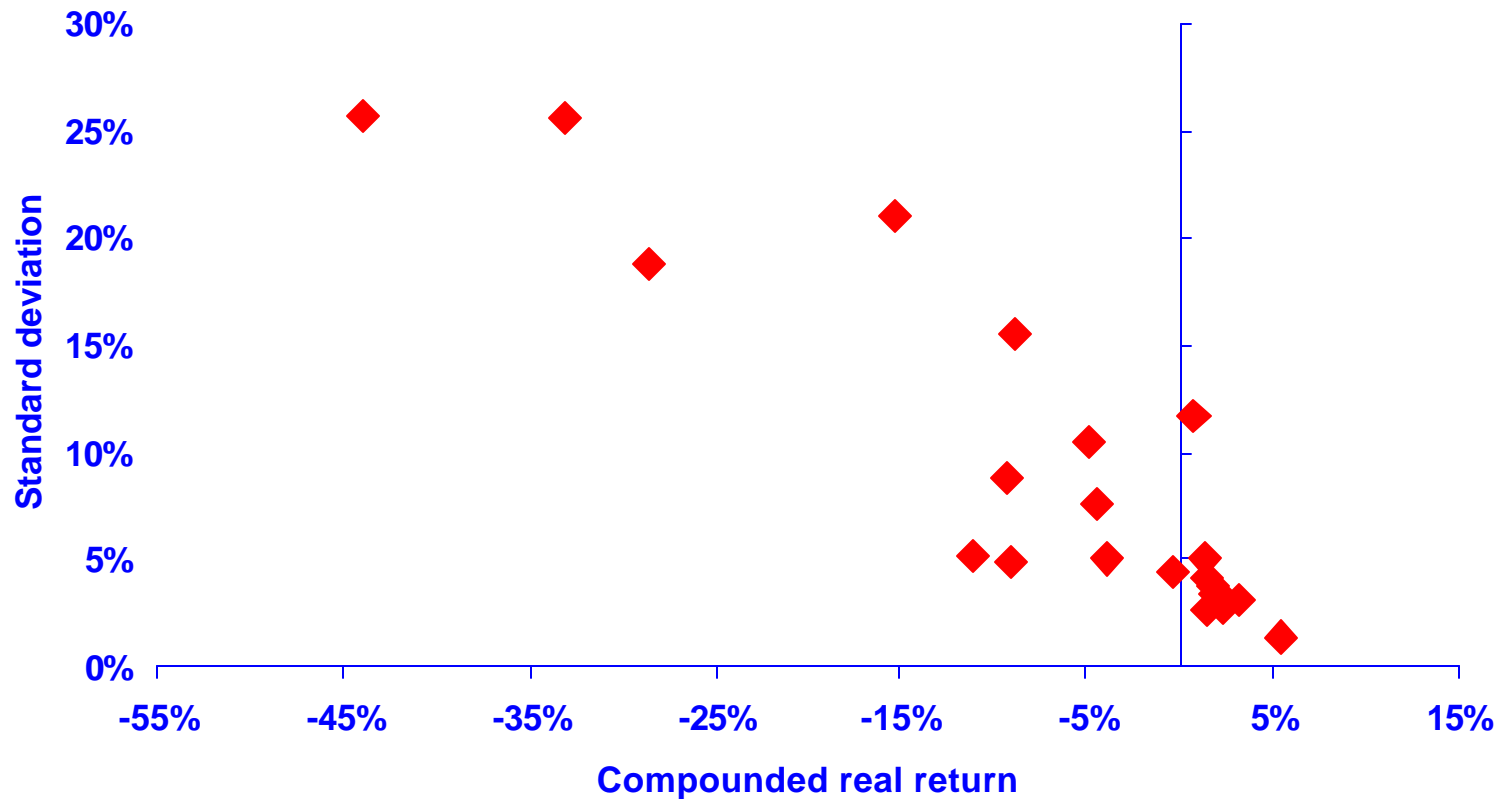
Sample: 115 countries

7 trillion US\$ in publicly
managed funds

Global prevalence of public funds



Poor historical performance...



The policy debate context

- No longer is the debate about fully funded versus purely pay-as-you-go financing
- Once funding is assumed, main choices are central public funds or competing private funds
- The experience with the first option has not been positive
- Success is likely to depend on the answers to a set of questions that we will now raise

Public 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.”

- Highlights issues of:
 - Transparency
 - Conflicts of interest
 - Business operations

Member Risks

- Failure of government to meet its retirement incomes promises
- Use of funds for social policy objectives
- Underperformance due to directed lending or as a captive source of finance for government
- Loss due to corruption or mismanagement

Governance Principles

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

Example – Canada 1998

- The Canadian agency has a fiduciary duty to manage CPP funds “in the best interests of contributors and beneficiaries”
- And “to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss, having regard to the factors that may affect the funding of the CPP and the ability of the CPP to meet its financial obligations.”

Governance Principles

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

Canada (cont.)

Board Appointment process:

- A nominating committee recommends qualified candidates for the board of directors to federal and provincial governments
- Government employees are not eligible to be directors
- The Board is subjected to close public scrutiny
- Board members must uphold a Code of Conduct and disclose any potential conflicts of interest

Canada (cont.)

Skills and character:

- sound judgment, analytical, problem-solving and decision-making skills
- genuine interest in, and dedication to, CPP
- high motivation, with the time and dedication
- ethical character and commitment to serving the public

Qualifications:

- experience in a senior capacity in the financial industry
- broad investment knowledge (e.g., securities and financial markets)
- experience as a chief financial officer or treasurer of a large corporation or government entity
- recognized accreditation as an investment professional

Governance Principles

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

Approaches to Curtailing Interference

- New Zealand – disclosure of Government “directions” to Parliament and public
- Ireland – prohibits investment in Government bonds
- Canada – considered restriction of investments to indexes, but ultimately relied on objectives in the Act
- Dutch – “no room for socially initiated investments or for economically targeted investments”

Governance Principles

- d) The processes for formulating and executing scheme policies should be open and transparent*
- e) The government should establish the structure of delegations permitted within the scheme*

Governance Principles (cont.)

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

Governance Checklist

- Are the roles of the respective parties in the public pension scheme clear?
- 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?
- How well does the agency's internal and/or external governance systems compare with those imposed by the regulator of private pensions?

Accountability

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

Governance Disclosure APRA

- 1. Foundations**
 - 2. Key Roles and Relationships**
 - 3. Internal Accountability Framework**
 - 4. External Accountability Framework**
 - 5. Consequences of Failure to Meet Responsibilities**
-

Appendices

- Statutory responsibilities of Board members:**
- Matrix of Delegations**

Accountability

- b) As part of its disclosure of governance arrangements the managing agency should be required to publish its formal delegations of powers and responsibilities*
- c) Funding shortfalls should be identified and disclosed, along with the government's proposed remedial actions*

Accountability

- d) *The management agency should be subject to regular governance and performance audit*
- e) *The management agency should be required to report comprehensively on its decisions and performance*

Canada

- Under law, the CPP Board is to make investment policies public, release quarterly financial statements and an annual report and hold public meetings every two years in each participating province
- Fund performance is benchmarked against private sector pension performance
- Canadian administrative costs have fallen sharply

Accountability

- f) To the greatest extent possible, rewards for performance should be linked to delegated responsibilities and should be risk based*
- g) Managers should be required to review periodically (e.g. monthly) the exercise of delegations they have made*

Accountability Checklist

- Is there adequate information about the governance structures of the scheme and its managing agency?
- Is disclosure of conflicts of interest mandatory?
- Is there regular performance and governance audit?
- Are financial performance and condition based on sound accounting standards and revealed regularly?
- Is financial performance reported against established benchmarks?
- Is the government open about its liabilities under the scheme and subject to independent actuarial reviews?
- Are incentive structures transparent to the public, linked to delegated responsibilities and risk based?

Investment Policy Consistency

- Canada – objective to increase funding from 8% to 20% by 2017
- Consistent with target long-run rate of return of 4%
- New Zealand – objective to meet retirement income needs with Government's contribution set by formula to ensure that

Investment Policy

- a) *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*
- *Avoid social mandates*
 - *Avoid lending to Government and members*
 - *Avoid portfolio restrictions*
 - *Avoid market dominance*
 - *Exercise voice wisely*

Investment Policy

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

Investment Policy Checklist

- Is the investment policy fully documented and publicly available?
- Is the stated purpose of the scheme solely to benefit members?
- Does the policy permit lending to government and/or members?
- Is the target rate of return based on a long-term funding ratio?
- Does the investment policy deal with potential market dominance?
- Have all major risks been identified and the risk tolerance been defined by the Board.
- Are the processes involved in delegating and evaluating delegations clearly defined? Are benchmark for hiring and firing managers clear?
- Are investment parameters defined as restrictions and prohibitions or in terms of modern portfolio concepts?

Concluding Thoughts

- Driving principles behind framework are that the scheme should:
 - have clear objectives,
 - be free from conflicts of interest,
 - be operated in a transparent manner
 - be accountable to members
- Public pension schemes should be operated in the best interests of those who bear the tax burden of funding their financial failings