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TRANSPARENCY AND ACCOUNTABILITY

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1. Background

Last year the collapse of Enron, WorldCom and Andersens appalled investors all over the world. Millions of people saw their savings and pensions collapse. While the high-profile problems I have mentioned were mainly located in the United States almost all other countries had their share of similar, if smaller, collapses. Structures, standards and regulations can never be a complete defence against individuals determined to do wrong, nor can they wholly protect against a culture of corporate greed and loose ethics. Nevertheless, it was recognised in a number of countries that robust defences must be in place to ensure that savers, investors and employees are protected as far as possible from further problems of this kind.

New legislation and regulation affecting accounting and corporate disclosure and governance has been introduced in several countries. For example, in the U.S. President George W. Bush signed in to law the Sarbanes-Oxley Act in July 2002. The Act has the stated purpose of protecting U.S. investors by improving the accuracy and reliability of corporate disclosures made pursuant to the U.S. federal securities laws. In the UK reforms were proposed under reports by Derek Higgs and Sir Robert Smith as well as a review of the regulatory regime of the accountancy profession. The UK reforms are intended to raise standards of corporate governance, strengthen the accountancy and audit professions and provide for a more effective system of regulation of the accountancy profession.

The OECD produced Guidelines for Pension Fund Governance in July 2002 which were developed as part of an OECD project on financial governance and have drawn inspiration from the existing OECD Principles of Corporate Governance. The adoption of an EU Pensions Directive to harmonise the activities of institutions for occupational retirement provision is imminent. A primary aim of the first EU Pensions Directive is to ensure the security of pensions and one of its main requirements is the provision of comprehensive information to pension fund members and beneficiaries. National pension regulators and supervisors also all have some level of focus on accountability and disclosure in their requirements for private pension funds.

The increased focus on compliance, and in particular on accountability and transparency, in relation to corporate entities and private pension funds must also have an impact for public pension funds. Many of the issues are similar as is the potential for problems.

The Myners Review on Improving Institutional Investing in the UK included recommendations on benchmarking and transparency. Myners recommended that the trustees of pensions schemes would regularly inform stakeholders about the pension schemes investment principles and strategic plan and about how performance relative to the plan is unfolding. He would like to see the trustees explain any departure from the principles and the plan. He also wants an internal information system that relates achieved investment results to the accountabilities for those results, including the contributions the trustees themselves are making.

2. Relevance

Accountability is an essential part of good governance. Without a system of accountability, governance cannot be monitored or improved. In fact, it could be said that good governance is a function of the responsibilities and accountabilities of key players in relation to the entity.

The need for transparency and accountability for public funds is self-evident. If public funds do not have confidence and support from those for whom they are established they are unlikely to be successful or even to continue to exist. Also, public awareness and interest is probably the best discipline for such funds. If there is transparency and accountability this will in itself create a demand for good overall governance.

Research has been done to examine possible links between different aspects of public pension fund governance on public pension performance[1]. Whilst there are some differences in the results these would seem to suggest that governance has a significant impact on public pension performance and that inconsistent performance is associated with indicators of poor governance. As accountability is an essential of good governance it would therefore appear to have a clear link with performance.

In an examination of drivers of organisational performance it was found that in private pension funds organisational performance is strongly correlated with certain governance indicators of which one is good mechanisms to understand and communicate with plan stakeholders[2].

[1] Mitchell and Hasin (1997), Useem and Mitchell (2000)
[2] Ambachtseer (2001)

3. Key Components

The Key Components

The first component for accountability is that there must be a focus of liability on a governing body or person who is in turn accountable to someone. If responsibility is not clearly imposed there is no scope for clear accountability and the result is likely to be confused decision making.

The governing body or person must itself comply with good governance requirements in the running of its own entity as well as in relation to its running of the public pension fund. For instance, if it is a corporate entity it must comply with accounting and other requirements applying to a corporate entity of its kind.

Effective accounts and audit requirements serve two purposes. They monitor and confirm the financial dealings of the Fund and also serve as a form of communication with the public for important financial information. A key concern in this area in recent times has been the question of auditor independence and the US, UK and other countries are currently bringing in new requirements in this area.

Effective custody requirements are another important feature. The assets must at all times be held in safe independent custody as otherwise all of the other requirements will be worthless at the end of the day.

Public transparency and reporting to all stakeholders should be at the heart of a public pension fund. A public pension fund is made up of the public's money which came directly or indirectly from them in the first place and is intended for the provision of retirement income for them in the future. The public need to know and understand what is happening to their money and what they can reasonably expect in the future. Public pension funds can have a variety of other stakeholders and a high level of transparency and accountability also applies to these.

In order to provide a safeguard for the public pension fund it is desirable that there would be independent oversight rather than leaving everything in the control of the governing body or person. As well as providing a safeguard this independent oversight also helps to create and maintain public confidence.

Each of these key components is discussed in more detail below.

Focus of Liability

It is easy to identify the focus of liability for a private pension fund and this is almost always confirmed by the relevant national legislation under which private pension funds operate. It is not so easy to establish a clear focus of liability for a public pension fund because of the large and sometimes diverse number of stakeholders involved. The most important stakeholders should be the current and prospective beneficiaries although, of course, the interests of current beneficiaries and prospective beneficiaries can differ. The Government is also an important stakeholder in any public pension fund because provision of retirement income systems must always be a direct or indirect Government concern. The relationship between the various stakeholders should be clear and in particular the relationship between the governing body, the Government and the public.

It is important to have a governing body or person where the responsibility is clearly focused. Lack of clarity on this will end up with confusion, poor decision making and consequent poor performance. Whether or not the responsibility should be a personal one is a matter of debate. It has been suggested that personal liability of truly independent governors should be established[3]. Others would suggest that it may be sufficient to focus the liability on a corporate entity of some sort rather than making it personal. However, most would agree that even if personal liability is not a feature then there should at least be some form of personal accountability to an independent body.

A further difference between public and private funds is that public pension funds do not usually come within the scope of national pension supervisory authorities. As the governing body does not usually report to the national pensions supervisory authority it cannot be left in a vacuum where it is not accountable to anyone. As it is a public fund the ideal person to whom it should be accountable is the public's representative body which is, of course, Parliament.

Good Governance of Governing Body

This requires that the governing body is itself practising good governance as appropriate to its legal status. An important feature of operating this would be the need for independence of the governing body. In particular, it needs to be independent from political pressure which is one of the biggest threats to any public pension fund and can take many direct and indirect forms. Clear statutory independence is probably the best guarantee that the governing body can have although it is not an absolute guarantee. Sound appointment and removal procedures for governors or directors of the governing body are important. These should be transparent and open so that they inspire public confidence.

Conflict identification and management is also necessary. It is impossible to appoint people where there can be a complete assurance that no conflict will ever arise either in relation to the assets, investment or beneficiaries of the fund. The important thing is to have an open and transparent method of identifying these conflicts and dealing with them when they do arise. There must not only be no conflict in decision making or influence but there must also be clearly seen to be no conflict. The objective of conflict identification and management is to prevent any actions being taken which are not in the interests of the beneficiaries.

The responsibilities and requirements for members of the governing body must be clear. They must understand what they are there to do in order that they are in a position to deal with their responsibilities in an efficient and effective way.

Clear mandates and objectives are also very important in that it is hard to discharge accountability requirements or to measure their effectiveness if the original mandate and objective are not clear to all involved.

Effective Accounts and Audit

Accounts should be required at regular intervals. These intervals should be clearly defined as otherwise it gives scope for selection which may be used to avoid clear measurement and comparison. They should be prepared to the highest national

[3] The Governance of Public Pension Fund Management – Gregorio Impavido (2002)

accounting standards. It is currently a problem in many areas of global trade and markets that there is not yet widespread use of international accounting standards. This makes it difficult to get the best value from accounts and to make valid comparisons. Work is being done in this area and we are likely to see some progress in the coming years. For the moment, probably the highest aspiration for public pension fund accounts is that they comply with best national accounting standards.

The accounts should have prescribed contents, ideally as a statutory requirement. This is particularly necessary in relation to disclosure of specific fees and expenses which may have been incurred.

An internal auditing function is desirable but not essential. What is essential is that there must be an audit provided by external auditors who are truly independent. There should be a time frame for when this audit must be completed and it should be at regular intervals coinciding with the timing of the accounts preparation and publication dates. The audit should adhere to highest national auditing standards. At present, there are still differences of opinion between countries on the most appropriate auditing standards and the supervision and regulation of auditors. This means that there is no appropriate standard at this time other than the national standard in the relevant country. The audit should include an actuarial valuation of assets and liabilities as appropriate and this should again be done independently and to the highest national professional standards for actuaries.

I have heard some discussion on development of an international standard for accounting and auditing of public funds. This would be a useful development and I hope that it will be pursued by interested parties.

Effective Custody

Custody is an essential feature of any fund. It has to be external and should be a totally independent institution from anyone connected with the fund in other ways. It should also, of course, be a reputable institution and should not only be independent and reputable but should be clearly seen to be independent and reputable. There are a number of effective global custodians now operating and whether one global custodian or a number of separate custodians are used it is important that all relevant areas are covered for custody purposes.

Public Transparency and Reporting

Reports should be published at regular intervals. The intervals should be prescribed in order to avoid selection which works against a clear comparable picture being presented. The contents of the reports should also be prescribed so that all relevant areas are included.

The publication of a regular report forms an appropriate basis for a formal reporting mechanism to whoever the governing body is accountable, preferably to Parliament. Where this report is being presented to Parliament there should be a formal structure in place for the report to be presented or laid before it so that Parliament has to give the report some level of consideration.

Such reports should also be publicly promulgated and ideally this process should be truly “public” where there is wide awareness of the report publication and availability.

There should be a clear mechanism for the public to seek and obtain the report and any other relevant information in relation to the Fund. This can be most appropriately done through the media and through the use of a website.

Where the fund has actual beneficiaries or potential beneficiaries then they will be required to be given specific information on their current or prospective entitlements. This would include statements of benefits which are expressed in clear unambiguous terms.

Independent Oversight

External examination and verification is an essential feature because there is a public interest issue involved. This would ideally take the form of at least an external audit, external actuarial valuations of assets and liabilities, and external verification of investment returns.

It is desirable that the Government or some other party to whom the governing body is accountable has the right to commission independent examinations of any area or aspect which is a cause of concern to the Government or to the public. It is probably best that the scope for such an examination is not clearly defined since there would then be a danger that some area which had not originally been envisaged would be excluded. It could be left to some form of “public interest” test.

4. Good Models – What They Do

Good Models

Levels of transparency and accountability vary greatly amongst public pension funds. This is, of course, influenced by the culture within which they operate. When I did some informal research on what public funds were considered to be good models for transparency and accountability there were three constant names mentioned. These were the Canada Pension Plan, the Norwegian Government Petroleum Fund and CalPERS. It is not perhaps a coincidence that these three funds are also considered to be successful and good examples of public pension fund performance. The remainder of this section looks at some of the key features of these good models.

Canada Pension Plan

A principle of the Canada Pension Plan (CPP) is that good governance leads to positive outcomes by defining responsibilities and accountabilities. A key principle of the plan's governance is disclosure. This commitment is underpinned by the Canada Pension Plan Investment Board Act which contains detailed provisions dealing with matters such as financial disclosure, auditing, public meetings and availability of information.

The CPP has clear roles with the CPP Investment Board (CPPIB) being the party with responsibility to invest funds in capital markets. Independence from political interference is achieved by having two separate juridical persons for the CPP and CPPIB. The objects of the CPPIB are clearly defined in the legislation as being to manage amounts transferred to it in the best interests of the contributors and beneficiaries and to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss.

The appointment of CPPIB Directors is subject to a process which is designed to ensure independent appointments and minimise the risk of any political interference. The CPPIB codes of conduct are public documents and contain a number of interesting features. These include tight controls on the personal investing of directors and employees. Directors and employees are required to clear trades before executing them for their personal accounts and to report on their investment activity on a regular basis. Another key aspect is the requirement for a director or employee of the Board to disclose in writing or request to have entered in the minutes of a meeting of the board of directors or one of its committees any director's interests which would constitute a conflict. Such disclosures must be made in a timely fashion and lead to restrictions on the director's right to vote or participate in discussions on any relevant transaction. Failure to comply with the conflict disclosure requirements can lead to the courts having the right to set aside the transaction.

The CPPIB is required to establish an audit committee. The duties of the audit committee include:

- Requiring the Board to implement internal control procedures and reviewing, evaluating and approving these procedures;
- Reviewing and approving the Board's annual financial statements and reporting to the Board on these;

- Meeting with the Board's auditors to discuss the annual financial statements and the auditor's report;
- Reviewing all investments and transactions that could adversely affect the return on the Board's investments that are brought to the committee's attention by the Board's auditor or officers.

The CPPIB is required to appoint an independent auditor and for this purpose independence is a question of fact. This external auditor has strong and clearly defined rights to information for the purpose of carrying out its work. Another requirement is that the CPPIB is required to adhere to a procurement policy in relation to its selection of all outside providers of services. It must also appoint an external custodian and there is a detailed process of due diligence for the selection of this custodian. And there are procedures for determining signing authorities and limits to protect cash and portfolio assets.

Further provision contained in statute is that the relevant Minister may appoint an auditor to conduct a special audit of the CPPIB or any of its subsidiaries. Also, the Minister must cause a special examination to be carried out at least once every six years in respect of the CPPIB or any of its subsidiaries to determine if the systems and practices relating to financial and management control were maintained in a manner which provides reasonable assurance that they meet the statutory requirements.

The actual reporting requirements for the CPPIB are clear and prescriptive. A quarterly financial statement must be prepared and sent to the relevant Minister and appropriate provincial Ministers within 45 days after the end of the three month period to which it relates. There is also a requirement for an Annual Report which must be provided to the relevant Minister and appropriate provincial Ministers within 90 days of the end of each financial year and copies of this report must be made available to the public. After receiving the Annual Report the Minister shall cause it to be laid before each House of Parliament on any of the next 15 days during which that House is sitting. The Report is also made widely available through stakeholder groups, availability in public libraries and it is posted on the CPPIB website.

The CPPIB Annual Report contains:

- The financial statements for the previous year;
- The auditor's report for that year;
- A certificate, signed by a director on behalf of the Board of Directors, stating that the investments held during that year were in accordance with the legislation and the CPPIB investment policies, standards and procedures;
- A statement of the objectives of that year and a statement on the extent to which the objectives were met;
- A statement of the objectives for the next year and for the foreseeable future;
- A statement of the investment policies, standards and procedures.

It also contains:

- A statement of corporate governance;
- Information on Board committees;
- Decisions requiring Board approval;
- Information on the total compensation of the top-5 officers of the CPPIB.

The CPPIB transparency and reporting includes:

- Rates of return;
- Market value of assets;
- Conference calls;
- Public meetings;
- Effectively conducting a broad dialogue and reporting campaign with Canadians from coast to coast.

The CPPIB have stated that their aim is "disclose, disclose, disclose" and their legislation and reporting would appear to clearly support this stated aim.

Norwegian Government Petroleum Fund

The Norwegian Government Petroleum Fund is established in a way which has very clear accountability. The Ministry of Finance is the "owner" of the Fund and decides the investment strategy and benchmark. Major changes are debated in Parliament. The central bank, Norges Bank, is the operational manager and is responsible for "value-added" against the benchmark. The Ministry also uses independent consultants to get second opinion view on performance.

The Norges Bank reports results, risk and costs every quarter. These reports are released at press conferences and on the internet.

The Petroleum Fund also produces a detailed annual report. This contains:

- A statement of the mandate for the Fund;
- The return on the Fund in the relevant year;
- Fixed income management;
- Equity management;
- Risk exposure;
- Organisation of management;
- Management costs; and
- Reporting of the accounts.

It also contains:

- The auditor's report;
- The management mandate;
- The organisation chart of Norges Bank;
- Holdings of equities at year end;
- Fixed income investments at year end.

A particularly attractive feature of the Petroleum Fund annual report is the Key Figures shown at the beginning of the report. A copy of these as included in the Annual Report 2002 is attached as **Appendix A.** Another excellent feature is the cost comparisons with other funds. This involves submission of data to a Canadian consulting firm Cost Effectiveness Measurement Inc. (CEM) which has a database containing cost figures for capital management in more than 150 pension funds. From this database, the CEM selects a peer group with on average the same total assets as the Petroleum Fund. The costs of this group are used as a basis for assessing the costs of managing the Petroleum Fund.

The Petroleum Fund Annual Report is a model of transparency. Further information is available at Norges Bank's website: www.norges-bank.no . The overall result is a very high level of transparency and accountability.

California Public Employees' Retirement System (CalPERS)

CalPERS is the largest public pension fund in the US and amongst the highest profile and largest pension funds in the world. Its core values are quality, respect, integrity, openness and accountability. Its guiding principles include providing meaningful information and education to all constituents in a timely manner. An interesting feature of CalPERS is the blending of its values and its business practices. In this context its business philosophy includes "demonstrating accountability by taking responsibility for our actions" and "supporting open communication". Its strategic goals also prioritise this issue and include fostering an environment that values openness and accountability.

CalPERS meets the first component necessary for transparency and accountability in that there are clear fiduciary duties for those responsible for management, investment and administration.

The CalPERS governance structure includes a high level of accountability to beneficiaries and it has also adopted a policy of full disclosure to beneficiaries which extends beyond its regulatory requirements. This clear commitment to transparency and accountability within CalPERS has enabled it to pursue corporate governance activism in the market which it is believed have led to improvements in performance. For instance, in March 2003, CalPERS named and shamed those companies on which it will be focussing its corporate governance activism in the coming proxy season. Out of 1800 US corporations in which CalPERS invests, 6 have been highlighted for their poor corporate governance and a feature of this criticism has been failure to communicate.

CalPERS constantly tries to improve its disclosure. For instance, in March 2003 it announced that it will be improving the disclosure of its private equity investments to provide a higher level of transparency. Following a vote by the board of administration, the Fund will now publish internal rate of returns for its fund and fund of funds, and amounts of cash invested and profits realised from that cash investment. The disclosure will be made on a quarterly basis. This information had been available before 2001 but had been withdrawn at that time. However this decision was now reversed based on the aim expressed by the president of the board as being to "provide the highest level of transparency that will not conflict with our fiduciary duty to our members – to maximise investment returns".

A key feature of CalPERS transparency and accountability is its comprehensive website. This website includes:

- Information on corporate governance;
- Names and occupations of its trustees;
- A board meeting calendar and agenda;

- Laws and board decisions;
- Its approach to corporate governance;
- A “guest” section where questions can be asked/comments made;
- Its investment policy.

A CalPERS website overview is attached as **Appendix B.**

Irish National Pensions Reserve Fund

I would also like to suggest the Irish National Pensions Reserve Fund as a good model which scores well on the key components for transparency and accountability. However, as I am presenting “Public Pension Funds Accountability: The Case of Ireland” later in this conference I will describe the transparency and accountability of the Irish Fund at that time.

5. Models with More to Do

South-East Asia Region

South-East Asian experiences with public funds have had mixed results. This is for a variety of reasons but lack of transparency and accountability has been suggested as an issue. South-East Asia has extensive Defined Contribution schemes, which are by definition funded. This is consistent with emerging international trends in financing retirement. It has been suggested that to obtain maximum economic benefits from these schemes, the region needs to improve pension fund governance including transparency and accountability and that this may require the setting up of Provident and Pension Funds Authorities[4].

Central Provident Fund in Singapore

It has been suggested in relation to the Central Provident Fund (CPF) in Singapore that the process of actual investment of CPF balances has raised transparency, adequacy and fiduciary responsibility issues[5]. Reforms mentioned include higher priority being given to fiduciary responsibility by the CPF Board and greater transparency of the investment process and outcome. It has also been suggested that the non-transparency and non-accountability of the CPF balances, along with administered rate of interest has turned the CPF from a nominally Defined Contribution fully funded scheme to a notional Defined Benefit scheme financed on a PAYG basis.

Japan

The Japanese Government Pension Investment Fund (GPIF) reports to the Minister of Health, Law and Welfare. This Minister has political rather than economic responsibility which may present a weakness in the reporting responsibilities of the GPIF. In relation to this scheme, it has been suggested that an area where there is room for improvement is in relation to full disclosure of information[6].

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[4] Mukul G. Asher – Mercer Global Investment Forum
[5] Mukul G. Asher – Mercer Global Investment Forum
[6] Masaharu Usuki – Public Pension Fund Management Conference 2001

6. Conclusion

Transparency and accountability are essential ingredients for good governance. All principles of governance, such as the OECD Principles of Corporate Governance, recognise this.

There is increasing global focus on transparency and accountability as a response to recent corporate and accounting problems. The issues which needed to be addressed for corporates also apply, and, in fact, could be said to be even more relevant to public pension funds.

Whilst it is not always possible to establish clear linkages between successful funds and good standards of transparency and accountability there is enough empirical evidence to make this linkage. Some of the examples quoted in this presentation would appear to support this view.

Public pension funds with high standards of transparency and accountability are useful as models. However, there is no ideal model as the transparency and accountability put in place needs to be country specific. It should be based on the capacity of that country to regulate, its standards of accounting, trust law if this applies and the general governance quality operating within the relevant country. This applies to all global or cross-border standards because what is effective in one country may not work in another.

And finally, whilst good transparency and accountability requirements must be enshrined in legislation and regulation that is not enough. It must also be made to work, and be seen to work, in practice.

Appendix A

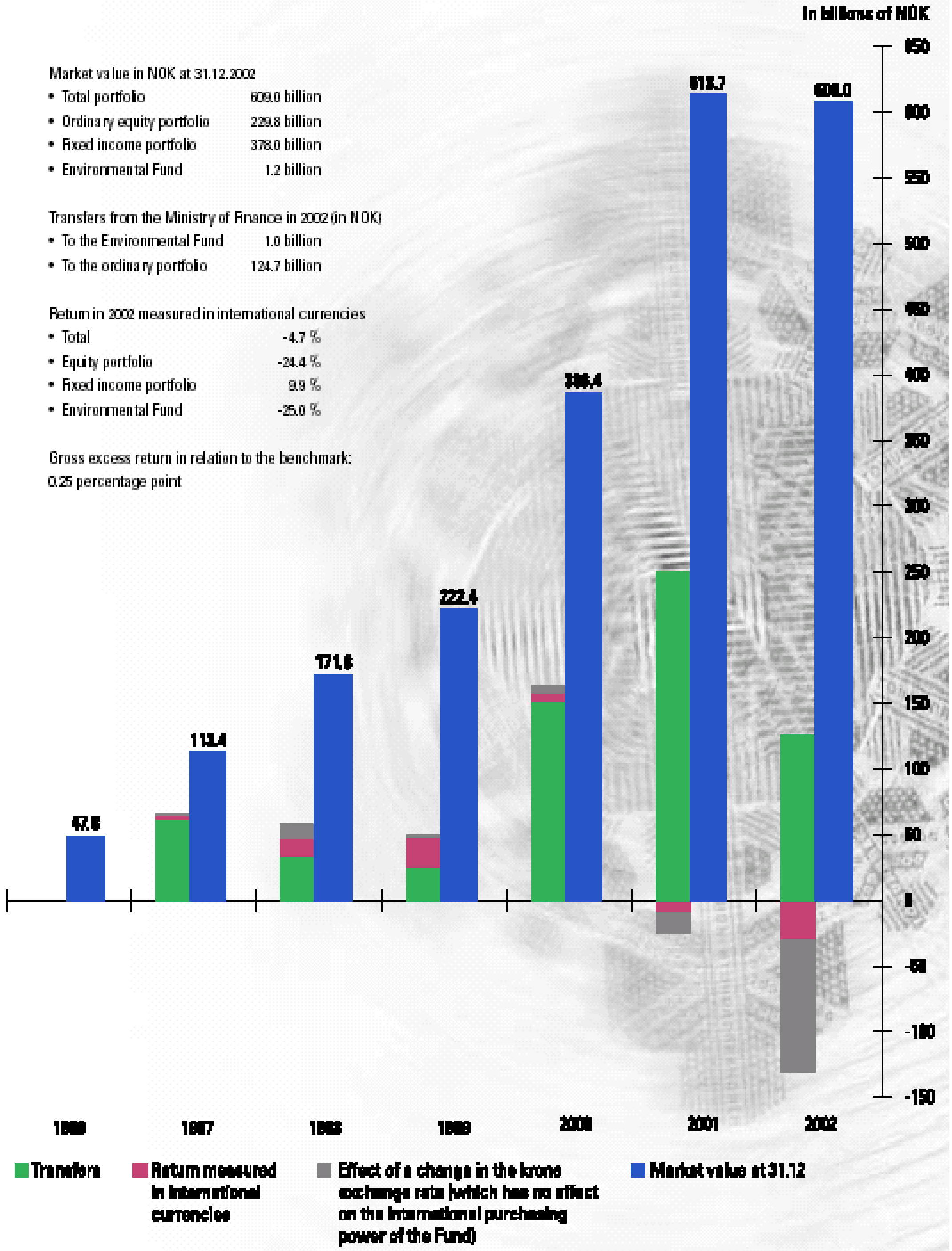
The Government Petroleum Fund – key figures 2002

Market value in NOK at 31.12.2002
- Total portfolio 609.0 billion
- Ordinary equity portfolio 229.8 billion
- Fixed income portfolio 378.0 billion
- Environmental Fund 1.2 billion

Transfers from the Ministry of Finance in 2002 (in NOK)
- To the Environmental Fund 1.0 billion
- To the ordinary portfolio 124.7 billion

Return in 2002 measured in international currencies
- Total -4.7 %
- Equity portfolio -24.4 %
- Fixed income portfolio 9.9 %
- Environmental Fund -25.0 %

Gross excess return in relation to the benchmark:
0.25 percentage point



Appendix B

http://www.calpers.com/site/site.htm