Although not managed as prefunded schemes, most of the public pension schemes in the Middle East and North Africa region have accumulated reserves. Among the countries reviewed, the reserves range from 4.2 percent of GDP in Djibouti to 52.5 percent of GDP in Bahrain. At the aggregate level, the reserves of mandatory pension systems account for 14.4 percent of regional GDP. This is among the highest levels in the world, second only to South Asia (see figure 5.1).

Recently, the issue of pension fund management has attracted considerable attention by policy makers, practitioners, and development agencies. One of the main motivations is that, in general, public pension funds have been mismanaged and performance, as measured by most reasonable standards, has been poor (Iglesias and Palacios 2000). Around the world, reserves in partially funded public schemes have been used to subsidize housing, state enterprises, and various types of economically targeted investments. They have been used to prop up stock markets and as a captive source of credit, and they probably have allowed governments to run larger deficits than they would have otherwise. Investment decisions typically occur in a regulatory vacuum, with little public accountability, limited access to information, and obscure management processes.

International experience suggests that progress toward improving the management of public pension funds relies on the presence of good governance, meaning the systems and processes that a company or the government uses to manage its affairs. The main components of good governance include transparency, systems for conflict resolution, and accountability for each function and role.

This chapter compares the management practices of pension funds in Middle East and North African countries with best practices at the international level and identifies realistic options for reform. The chapter starts by outlining core principles for better governance, accountability, and investment policy. It then benchmarks current practices along these three dimensions in Middle East and North African countries and
identifies major weaknesses. The final section discusses the constraints on introducing structural reforms in the region and proposes a set of practical guidelines to improve management in the short and medium terms.

Lessons from International Experience in Pension Fund Management

A recent comprehensive review of international best practices identifies core principles for good governance, accountability, and investment policies. These are summarized in this section and presented as a benchmark to assess the current challenges that countries in the region face.

General Principles of Good Governance

The governance provisions of public pension schemes should aim to establish good business practices and avoid corruption, mismanagement, and abuses by the government itself. According to recent evaluations of
international experience, the following principles and guidelines should improve the governance of publicly managed pension schemes.

**Mandate of the Governing Body**
Within the pension fund, roles and responsibilities should be clearly defined. An example can be found in the Canadian pension reforms carried out between 1995 and 1998. Under the Canadian Pension Plan (CPP) Investment Board Act of 1998, the board has a clear fiduciary duty to (a) manage CPP funds in the best interests of contributors and beneficiaries and (b) invest its assets to achieve the maximum rate of return, without incurring undue risks and while taking into account the factors that may affect the funding and ability of the CPP to meet its financial obligations.

**Selecting the Governing Body and Shielding Funds from Political Interference**
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. For example, in Canada, the finance minister, in consultation with provincial governments, appoints the 12 members of the CPP board. The appointment process involves a nominating committee that recommends qualified candidates to the federal and provincial governments. The board and the appointment process are subjected to close public scrutiny, and candidates for the board, in addition to having suitable qualifications, must meet demanding skill and character requirements.

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. New Zealand has chosen the route of full disclosure. Under New Zealand law, the minister has explicit power to direct the governing board of the public pension fund. However, directions must be submitted in writing, presented to Parliament, and published in the official gazette. Ireland takes a slightly different approach, explicitly prohibiting investments in Irish government securities and thus restricting one avenue by which the government could misuse the fund for its own purposes.

**Minimizing Corruption and Fraud**
The management agency should be required by law to establish internal governance structures and processes aimed at minimizing corruption, mismanagement, and fraud. Governance procedures should include
(a) the mandatory establishment of a risk management and audit committee; (b) a code of conduct for staff and senior executives; (c) a detailed description of the roles and responsibilities of different groups within the agency; and (d) a process of quality control and rigorous documentation, review, and audit requirements for investment decisions and information technology support systems.

**Supervision**

The government should require the management agency to be regulated and supervised by the same agency responsible for regulating private pension providers and, where feasible, to meet the same standards imposed on private providers. Canada has not placed its public fund under the jurisdiction of any of its private sector financial regulators, but it has imposed a similar set of standards for governance and investments as those required of the private sector. In contrast, Indonesia is proposing to place the public pension fund under the same regulator as private pension funds. This is already the case in Costa Rica, Kenya, and Morocco.

**General Principles of Accountability**

Structures that provide managers with incentives to comply with their mandate and run the pension fund in the best interests of plan members are central to the achievement of good governance. To this end, two basic elements need to be considered: transparency and reward structures. Regarding transparency, the objective is to fully disclose information (for example, the financial situation of the scheme, the composition of the portfolio, investment decisions, and performance). Regarding reward structures, the goal is to ensure that those making decisions are held accountable. Good judgment and good performance should be rewarded, while poor judgment and bad results should be penalized.

**Disclosure of Governance Structures and Responsibilities**

There should be full and open disclosure of the governance structure of the scheme and the managing agency, including rules for selecting members of the governing body and managers. Accountability requires that details about the governance structure be made public. In particular, there should be adequate disclosure of the arrangements put in place to detect and prevent fraud. As part of its disclosure of governance arrangements, the managing agency should be required to publish its formal delegations of powers and responsibilities. Once the agency has formalized its structure of delegations, it should make these available to all stakeholders.
Disclosure of Policy Making, Performance, and Financial Situation

The management agency should be required to report comprehensively on its decisions and performance. This is arguably the key accountability issue. Full disclosure of performance in both absolute and relative terms is fundamental to protecting the interests of plan members. 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. Where the government has an explicit policy of partial funding, the extent of the underfunding should be assessed and reported in the government’s accounts. Both Canada and Ireland use publicly disclosed benchmarks for comparing performance. Canada uses the benchmark of fund performance in the private sector, while Ireland uses a predetermined set of benchmark indexes. In addition, Canadian fund managers are required to hold public meetings in each province at least every two years to discuss performance. Since instituting this type of public reporting, administrative costs have fallen more than 60 percent.

The management agency should be subject to regular governance and performance audits. This practice is common in many countries. In Canada, in addition to the annual financial audit, the CPP is required to initiate a special examination of management practices at least once every six years.

Incentives, Rewards, and Sanctions

To the greatest extent possible, incentives and 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. Managers should be required to review periodically the exercise of delegations they have made. Compliance should be rewarded, and breaches of guidelines, either for governance or for investment, should be penalized, even where the returns are higher than expected.

General Principles of Investment Policy

Public pension fund managers have the responsibility to select an investment strategy that balances risks and returns appropriately for plan members. The investment policy comprises three main components: setting long-term performance targets, defining an acceptable level of risk tolerance, and setting parameters for short-term asset allocation. These need to be set out clearly in an investment policy statement.

The primary focus of investment policies for private investment funds is to balance market risks and returns. Three types of risks need to be
managed: (a) the risk of loss due to counterparty default, (b) the risk of loss due to movements in market prices, and (c) the risk of loss due to operational failure. In addition to these risks, public investment funds need to be concerned about their role in the domestic capital market and their exposure to government debt. In the private sector, the market risk dimension of investment strategies is increasingly expressed as a comprehensive measure of risk, such as value at risk. This comprehensive measure of risk automatically signals inadequate diversification. Therefore, funds can be managed effectively in the absence of strict sectoral limitations or target ratios. However, this approach has yet to reach far into the public sector, where investments often are handicapped by limited mandates and restrictions that militate against modern risk management practices. Nevertheless, some principles emerge from international practice to ensure prudent management and improve the efficiency of public funds. These principles are discussed below.

**Setting Investment Policy**

The investment policy should be set by the board of directors or trustees. It should be fully documented and should be available in summary form to members of the scheme. Clearly, for competitive reasons, the publicly disclosed elements of the investment policy should focus only on general strategies and attitudes toward risk. The strategy should be aligned with the objectives of the fund and should be shielded from political influence.

**Mandate of the Investment Policy**

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. A policy that is directed solely to the interests of fund members will have few, if any, prohibitions on investments. The interests of fund members will be enhanced by sound diversification of risks. In general, rules that limit or prohibit investments, including investments in foreign securities, reduce the capacity of the fund to diversify and to serve the interests of fund members. The two exceptions to this general rule are loans to related parties—either the government or plan members—and investments in risky derivatives.

**Market Power and Corporate Governance**

The investment policy statement should identify the potential for the fund to be or to become a dominant force in the domestic market and should specify how the fund would resolve such a situation. The investment policy should be explicit about how the pension fund would
exercise its voting rights as a shareholder. The exercise of voice is important but, to avoid a situation in which the government de facto directs private business, it is usually better to delegate this power to the fund managers. One way to minimize the conflicts of interest that may arise from such situations is for the fund to publish, with a lag time, a summary of the way in which it voted in its various shareholder capacities. Fearing the potential for pressure on the public fund to influence corporate governance for purposes other than those in the interests of the fund itself, some countries have imposed concentration limits or delegated voting rights to fund managers; others, such as Sweden, have put a cap on the effective voting power of the fund. In all cases, however, a policy for shareholder voice should be explicit and documented.

Assessing and Managing Risks

The investment policy should identify all relevant risks and the board’s approach to measuring, monitoring, and managing each risk. A particular problem arises from investments in nonmarketable assets. These investments reduce the liquidity of the fund and are more prone to malpractice at the time of acquisition, valuation, or sale. Assets can be purchased above market prices or sold below market prices to benefit fund managers. Even in the absence of corrupt practices, valuation problems can make it difficult to assess whether the asset is generating gains or losses.

In general, the investment policy should seek to minimize investment in illiquid assets. However, in many countries this may not be practicable, especially where funds are prohibited from investing in foreign assets. One way to contain the risks involved with investments in illiquid assets is to limit the amount to a benchmark maximum, set by the board, according to a realistic assessment of the spectrum of investments available. Where such investments are permitted, the board should establish a clear policy for their purchase, disposition, and valuation. The policy could include either mandatory independent assessment of each purchase and sale of illiquid assets or supervision by the audit committee of the board before the transaction occurs. This assessment should evaluate the price set for the transaction, the independence of the parties involved, and the appropriateness of the transaction for the fund, with respect to the targeted rate of return. To reduce the scope for corrupt practices, the prices and details of all transactions in illiquid assets should be disclosed to fund members and the public.

Investment policies should respect exposure limits, too. To diversify risk, funds should not invest more than 5 percent of their reserves in a single asset and should not own more than 5 percent of the liabilities of a given company. Respecting these rules reduces the influence that funds
might have on corporate governance and thus reduces the possibility of conflicts of interest.

Pension Fund Management in the Middle East and North Africa Region

None of the surveyed countries in the Middle East and North Africa region complies with the best practices of governance, accountability, and investment policies discussed in the previous section. In general, there are no clear mandates for the governing body of the pension funds, pension funds are not shielded from political pressure, investment policies tend to be opaque and do not respect guidance regarding risk exposure, and disclosure and accountability to plan members is weak.

Current Practices in Governance

Governance covers the mandate of the governing body, the process for selecting the governing body and shielding it from political pressure, mechanisms for minimizing corruption and fraud, and supervision.

Mandate of the Governing Body

Very rarely does the law establish the mandate of managing the fund in the best interests of plan members. Pension funds often have mandates that are not related to their core functions. In Egypt, the Islamic Republic of Iran, Lebanon, and Libya, for instance, the funds are explicitly mandated to finance economic and social development projects. The Conseil National de Sécurité Sociale (CNSS-Djibouti) in Djibouti and the Social Security Investment Unit (SSIU) in Jordan are the only institutions within the sample that endow governing bodies with the unique mandate of collecting contributions, paying benefits, and managing the funds in the best interests of plan members.

Selecting the Governing Body and Shielding It from Political Pressure

All of the pension funds under review have tripartite governing bodies that are poorly shielded from political pressure. While the number of governors varies, the composition in all cases includes representatives from the government, plan members, and employers. None of the countries has specific criteria regarding the profile of members of the governing body. As a result, selected members often lack the credentials and experience to manage the fund in the best interests of plan members.
Governments have a dominant representation, mainly through staff from the Ministry of Finance, Ministry of Labor and Social Affairs, or the central bank.

The chairman of the board is usually a representative of the head of one of these institutions. The fact that the chairman of the governing body and the director general are political appointees also creates high turnover in the governing body and the management team. This is particularly problematic in the region, where cabinets are subject to frequent reshuffling. These reshuffles are especially prevalent in Jordan and Lebanon.

In the majority of cases, the director general of the pension fund is appointed and removed by a high-level government official. In Djibouti, the appointment and removal of the director general are made jointly by the minister of labor and the minister of finance, although the president can overrule them. In Libya, the director general of the Social Security Fund is appointed by the prime minister without consultation. In the Islamic Republic of Iran, the heads of the two pension funds are appointed by the equivalent of the minister of planning, who is also the chairman of the governing bodies of the two institutions.

The main consequence of this type of arrangement is the emergence of conflicts of interest between the government and plan members, which impede effective control of corruption and fraud. There are many examples of such conflicts. In the Islamic Republic of Iran, the Civil Servants Retirement Organisation (CSRO) and the Social Security Organization (SSO) have recently signed an agreement accepting public companies—often with dubious financial situations—as payment for part of the government debt with the fund. Both funds plan to keep some of these companies and sell others after restructuring and recapitalization. De facto, both funds have been transformed into government agencies to restructure and privatize public enterprises. In the case of the SSO, the transferred companies represent roughly 40 percent of reserves. This policy benefits the government, but it is unlikely to benefit plan members.

**Minimizing Corruption and Fraud**

In general, responsibilities of the members of the governing body are loose. Very rarely does the law establish the mandate of managing the fund in the best interests of plan members. With the exception of the SSIU in Jordan and the Caisse Marocaine de Retraite (CMR) in Morocco, none of the laws creating the funds or the associated regulations clearly specifies the responsibilities of board members. Only the SSIU defines in general terms a code of conduct for staff and senior executives.

However, supervisory committees, investment committees, and audit committees are common, but their structure is likely to reduce their
effectiveness. In the Islamic Republic of Iran, both the CSRO and the SSO have investment and audit committees, but these are formed mainly by representatives of the government, managers of key companies owned by the funds, and senior members of the management team of the funds. The CMR in Morocco has an investment committee that determines internal rules, a placement committee that implements investment policies, and a supervisory committee that assesses performance, ensures that the implementation of the investments conforms to strategy, and ensures compliance with prudential rules. The supervisory committee, however, reports mainly to the minister of finance and includes three members from that institution. Moreover, the Ministry of Finance mandates the CMR to keep close to 90 percent of its reserves in government debt.

Weak governance also reflects weak administrative capacity. All funds define the organic structure of the agency and the functions of the different departments, but they do not evaluate the performance of the various units and their staff or implement quality control processes. With a few exceptions (for example, Bahrain, Jordan, Lebanon, and Morocco), information technology support systems are underdeveloped. In the Islamic Republic of Iran, even senior management has difficulty obtaining an integrated view of the allocation of assets and their performance.

**Supervision**

There is no explicit framework for regulation and supervision in any of the countries surveyed. Pension funds usually fall under the umbrella of the Ministry of Labor and Social Affairs or the Ministry of Finance (this is always the case in schemes for the military and civil servants). These ministries have representatives on the boards of the pension funds. Only in Morocco is the regulator for the insurance industry, which is within the Ministry of Finance, also in charge of monitoring all mandatory schemes.

**Current Practices in Accountability**

Accountability covers the disclosure of governance structures and responsibilities, the disclosure of policy making and performance, and the creation of incentives, rewards, and sanctions.

**Disclosing Governance Structures and Responsibilities**

All pension funds in the region make public the information regarding the structure of the governing body, which is part of the law. However,
the rules for nominating members, other than government representatives, as well as their specific responsibilities to the board are not transparent.

**Disclosing Policy Making and Performance**

Little information is made available to the public regarding the decision-making process within the governing bodies. For instance, none of the funds reports making public the minutes of the meetings of the governing body.

The main weakness, however, relates to reporting procedures and investment policies. All funds publish annual reports describing their financial situation, but these often are subject to significant delays, and the information tends to be neither relevant nor sufficient. For instance, with the exception of Bahrain, none of the reports reviewed contains sufficient information about investment strategies and outcomes. In the Islamic Republic of Iran, the annual reports are prepared for the governing body and other government institutions; the public does not have access to them. The publications that are targeted to the public take more the form of an advertising brochure listing the various activities in which the pension funds are involved.

Benchmarking of performance and independent auditing are insufficient, and the results are not properly disclosed. Overall, no clear criteria for benchmarking the operations and performance of pension funds have been defined yet.

In all cases, periodic audits and evaluations of investments are required, but these often are not executed by independent agencies. With the exception of Algeria, all pension funds conduct periodic actuarial valuations, either internal or external, but the results often are kept confidential. Only in Bahrain, Jordan, and Morocco do the pension funds report making use of external auditors who disclose the results of these valuations automatically. In the other countries, the auditors are government agencies or specialized departments within the institutions that administer the funds. Even in Jordan, where efforts have been made to improve transparency, the results of the actuarial valuations are not published or made publicly available. This situation impedes good governance and creates an additional avenue for the emergence of conflicts of interest.

This lack of transparency is likely to be amplified by, in general, limited understanding of plan members regarding the finances and functioning of the pension fund. In this context, information asymmetries are exacerbated, and the main stakeholders (contributors and beneficiaries) have limited ability to safeguard their interests. This reduces the incentives of managers to make policy decisions in the best interests of plan members.
Creating Incentives, Rewards, and Sanctions

The incentives of fund managers are not aligned with the interests of plan members in any of the countries surveyed. The delineation of responsibilities between the governing body and the management team is often blurred. This is evident in the Islamic Republic of Iran, Jordan, and Libya, where the managing director is also the chair of the governing body, which also includes other senior managers. In none of the cases does the governing body have the power to elect and remove the managing director, who is appointed directly by the government. Remuneration policies are not set by the governing bodies and are not linked to the performance of the management team. Mechanisms for rewarding good performance and penalizing bad judgment are lacking. The fact that the governing body does not appoint and remove the general manager of the fund also reduces incentives to respond to board policies.

Current Practices in Investment Policy

In the large majority of cases, investment policy is set on an ad hoc basis. Few funds attempt to define a coherent strategy that sets targets for acceptable levels of risk, expected rates of return, and asset allocations that match the maturity of liabilities. With few exceptions, there are no explicit mechanisms to assess and manage risks, and exposure limits in investments are not respected. The resulting investment policies are risky, with many funds overexposed to explicit and implicit public debt as well as direct investment in companies, which interferes with corporate governance. Lending to plan members and investments in real estate (and management of real estate property) are also widespread. Clearly, non-existent or shallow and narrow capital markets constrain investment choices over the medium term (see chapter 2). Still, with the exception of the Caisse Interprofessionnelle Marocaine de Retraite (CIMR) and the Caisse de Dépôt et de Gestion (CDG) in Morocco, which outsource the management of reserves, the majority of funds remain large players in these markets, which can discourage private investors. Some of these issues are illustrated next by reviewing investment policies in Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Libya, and Morocco.

In Egypt, all surpluses of the pension funds are invested in the National Investment Bank (NIB). Today, 63 percent of the NIB’s liabilities are with the pension funds (see table 5.1). By law, the NIB finances the government’s capital expenditures. In fact, the government is mandated to borrow from the NIB at a predetermined interest rate, which is currently above market levels (see figure 5.2). Interest paid on this debt accounts for 40 percent of revenues of the pension funds (see World Bank 2005c). When employer contributions and other transfers are
Management of the Public Pension Funds

included, the government is basically providing 80 percent of the revenues of the funds, which are generating a surplus of 6 percent of GDP. This surplus is deposited back into the NIB. This practice is contrary to the more common case, where governments consider pension funds to be a low-cost source of funding. In Egypt, the current arrangement

| TABLE 5.1 | Balance Sheet of the National Investment Bank in Egypt, 2002–4 |
| Percent | | | |
| Item | 2002 | 2003 | 2004 |
| Assets | | | |
| Government | 46.8 | 45.1 | 43.6 |
| Economic authorities | 19.4 | 18.2 | 17.5 |
| Other investments | 10.1 | 10.3 | 13.8 |
| Soft loans | 2.5 | 2.3 | 2.1 |
| Public companies | 6.5 | 7.0 | 7.4 |
| Joint venture companies | 0.7 | 0.6 | 3.8 |
| Other investments | 0.4 | 0.5 | 0.4 |
| Bank deposits | 1.2 | 3.2 | 1.3 |
| Other | 22.5 | 23.2 | 23.8 |
| Liabilities | | | |
| Social security funds | 63.6 | 63.6 | 63.7 |
| Investment certificates | 23.2 | 22.5 | 21.7 |
| Development bonds (US$) | 0.5 | 0.6 | 0.6 |
| Post office savings | 7.0 | 8.1 | 9.0 |
| Other | 0.5 | 0.7 | 0.7 |
| Other debt | 5.1 | 4.5 | 4.3 |

Source: National Investment Bank (NIB).

| Figure 5.2 NIB and Market Interest Rates in Egypt, 1979–2000 |

Source: NIB.
increases financing costs. In principle, this situation could be considered ideal for the pension fund, but it is unlikely to be sustainable in the long run. Close to 70 percent of the portfolio of the NIB is made of public debt (table 5.1). Ultimately, the liabilities of the NIB are a direct responsibility of the government. Given these circumstances, it might be more appropriate to consider the NIB not as an entity with an autonomous balance sheet but rather as a liability line in the general budget. At the same time, any reform program of the Egyptian pension system should aim at keeping the implicit debt of the scheme in the form of explicit government debt (see the discussion in chapter 4).

In the Islamic Republic of Iran, investment policies for both the SSO and the CSRO are highly complex and risky. The SSO has become a large industrial conglomerate with considerable market power in several economic sectors, which can impede private sector development and interfere with corporate governance. Up to 1976, the SSO invested its cash reserve fund in the Worker’s Welfare Bank in the form of fixed deposits. After creation of the Social Security Fund in 1976, the SSO started to diversify its investment activities, but by 1989 close to 80 percent of the portfolio was still composed of long-term deposits. By 2000, however, the share of deposits had dropped to 10 percent, while the share of indirect and direct investment had increased to 27 and 43 percent, respectively, or 70 percent of the total portfolio. The companies owned by the SSO (directly and through its investment company, Shasta) produce 43 percent of pharmaceutical and hygienic products, 36 percent of cement, 35 percent of televisions, 25 percent of fireproofing products, 31 percent of refrigerators and freezers, and 35 percent of rubber. The SSO is one of the most active investors in the stock exchange, with 11.3 percent of market capitalization in 2001. In addition, the SSO invests in government securities, provides financial support for public construction projects, accords liquidity to the banking system, and gives financial assistance to pensioners and contributors (for example, housing loans, marriage aid) at subsidized interest rates (see figure 5.3).

Clearly, the SSO has expanded its mandate too far, rendering it difficult for managers to assess the performance of investment policies and to implement corrective measures when necessary. Beyond problems of governance and disclosure, it is unclear whether the SSO has the resources (human and physical) to monitor effectively the operations of the large number of companies it owns directly or indirectly through Shasta. Since the managing directors of the companies know the limitations of the monitoring system, they are more willing to take risks. Some SSO staff have observed, for instance, that the managing directors of the companies often present unrealistic cost-benefit analyses to justify additional investments. During implementation, results usually diverge
dramatically from predictions and yet are approved during the meetings of the General Assembly. Another problem with the direct management of several corporations is that considerable resources need to be allocated to deal with administrative problems.

Other SSO activities, such as housing projects, lending to the corporate sector (including its own companies), and subsidized lending to beneficiaries, also incur administrative problems that divert the attention of the board and create conflicts of interest. A pension fund that concentrates on collecting contributions, paying benefits, and allocating investments does not need to consume resources for other activities. The Department of Economic, Investment, and Planning Affairs is currently proposing to break Shasta into smaller holdings that are more specialized but that would respond to the same governance structure. This is unlikely to bring sizable improvements in management, since incentives would remain unchanged.

The CSRO pursues two types of investment activities: direct investments, which are executed by the Department of Investments and Economic Affairs of the CSRO, and indirect investments, which are executed by the newly created investment company. Direct investments refer to investments in companies (that is, equity positions) that do not take place through the stock market. The level of CSRO ownership in these companies varies from 100 percent of assets, as in the case of a

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**Figure 5.3 Structure of the Portfolio of Investments of the SSO in the Islamic Republic of Iran, 1989–2000**

Source: Data provided by SSO Economic and Investment Affairs Department.

Note: *Indirect investment* refers to investments through the investment company Shasta. *Direct investment* refers to investments in companies directly owned by the SSO.
construction company, to less than 13 percent. Companies where CSRO ownership exceeds 50 percent of assets are managed directly. In companies where the CSRO owns between 13 and 50 percent of the assets, CSRO has representatives on the board of directors, and in companies where ownership is below 13 percent, the CSRO has no representation. Direct investment activities have intensified with the recent transfer of public companies to cover part of the government debt with the fund. Looking forward, however, the strategy is to prioritize indirect investment activities through the investment company, which was created to manage investments in the stock market. It currently has assets equivalent to 5 percent of total reserves (see table 5.2). In practice, fund managers have a very narrow margin of maneuver in which to reallocate assets and improve rates of return. To give the company some degree of autonomy from the CSRO, the investment company was created with its own “supreme council.” However, its supreme council is composed of the same members as the supreme council of the CSRO. There is no information about company-specific investment policies or strategies, except that investments cannot be above 15 percent of the capital of a given company (to avoid involvement in decision making) and that, above a given threshold, approval is required from the board of directors.

In Jordan, important reforms have recently taken place with the creation of the SSIU. The SSIU was established as an entity with its own board of directors, which has a classic tripartite structure (that is, representatives of government, employees, and the private sector). Three of the seven members are representatives of the Social Security Corporation (SSC), including the director general. The design of the SSIU’s organizational structure has been completed, and the majority of

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount (millions of US$)</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies transferred by the government</td>
<td>500</td>
<td>19.60</td>
</tr>
<tr>
<td>Investment company</td>
<td>125</td>
<td>4.90</td>
</tr>
<tr>
<td>Construction company</td>
<td>37</td>
<td>1.45</td>
</tr>
<tr>
<td>Long-term deposits</td>
<td>25</td>
<td>0.98</td>
</tr>
<tr>
<td>Government bonds</td>
<td>63</td>
<td>2.45</td>
</tr>
<tr>
<td>Loans</td>
<td>1</td>
<td>0.04</td>
</tr>
<tr>
<td>Government arrears, including interest and penalties</td>
<td>1,800</td>
<td>70.57</td>
</tr>
<tr>
<td>Total</td>
<td>2,551</td>
<td></td>
</tr>
<tr>
<td>Share of GDP</td>
<td></td>
<td>3.29</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations based on interview with the head of the Investment Department.
personnel have been hired. The hiring process has been conducted on
the basis of detailed descriptions of functions, skills, and required quali-
fications for each of the positions. Candidates were selected through a
highly competitive process. Personnel were not transferred automati-
cally to the SSIU from the former investment unit within the SSC.

The SSIU has prepared a statement of investment policy that follows
internationally accepted principles and practices regarding investments.
The statement emphasizes two principles of investing: (a) long-term
investment and (b) diversification. It states that investment policies will
be conducted with the main objective of benefiting plan members.
Although SSIU investments could contribute to the development of the
financial sector in Jordan, this is considered a by-product of investment
policies. The statement also emphasizes adherence to a strict code of
ethics, which forbids SSIU staff from taking advantage of information
gained in the execution of their function for their personal benefit. It
also forbids speculative investments and investment practices such as
short sales, complex derivatives, use of leverage, or speculation in for-
egn currencies. It calls for periodic evaluation and benchmarking of
performance. Finally, it emphasizes the importance of research and ed-
ucation: in particular, continuous training for staff and the systematic
evaluation of the various investment strategies that are implemented to
identify those that work, those that do not, and why.

After the reforms, which took place in 2001, the SSC portfolio moved
more aggressively into equities, while the share of real estate and of
loans and bonds was reduced considerably (see figure 5.4). Bank deposits,
however, continue to capture more than 40 percent of reserves. This can be risky, as all deposits are treated as a single account and thus insured at only JD 10,000. The main challenge is to develop and implement adequate outsourcing policies. Currently, the SSC remains a large player in a shallow capital market (see chapter 2). This can interfere with corporate governance and discourage the participation of other investors.

In Lebanon, the institution that runs the End-of-Service-Indemnity Program for Private Sector Workers (NSSF) has a tripartite board and an investment committee. The board is nominated for a period of four years. The investment committee is chaired by the general director of the NSSF and has as members a general manager from the Ministry of Finance, the general manager of accounting in the NSSF, and 11 members of the tripartite board. The chair of the investment committee is a political appointee, so there is little continuity, with frequent changes in government. The responsibilities of the investment committee of the NSSF are very limited. The present rule is that pension assets have to be invested 50 percent in bank deposits and 50 percent in government bonds. The Accounting Department of the NSSF makes decisions regarding the allocation of these assets among the different maturities. Investments in other types of instruments are prohibited according to the current rules. Table 5.3 provides details regarding the maturity of instruments in the two categories of investments and the average nominal interest rate earned. This investment strategy precludes the efficient diversification of risk, in particular through investment in long-term instruments.

In Libya today, no governing body is in place. The chairman of the Social Security Fund is nominated by the prime minister and his cabinet and has discretion in setting investment policies. In practice, the

<table>
<thead>
<tr>
<th>Type of investment and maturity</th>
<th>Total portfolio</th>
<th>Allocation</th>
<th>Average nominal interest earned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank deposits, 2003</td>
<td>50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 months</td>
<td>25.0</td>
<td></td>
<td>8.52</td>
</tr>
<tr>
<td>6 months</td>
<td>39.6</td>
<td></td>
<td>8.66</td>
</tr>
<tr>
<td>12 months</td>
<td>35.5</td>
<td></td>
<td>8.86</td>
</tr>
<tr>
<td>Government bonds, 2002</td>
<td>50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 months</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 months</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12 months</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 months</td>
<td>100.0</td>
<td></td>
<td>14.14</td>
</tr>
<tr>
<td>36 months</td>
<td>0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: NSSF.
decisions are subject to approval by the Ministry of Finance. The result is that the largest share of reserves, around 64 percent, is allocated to government debt, which is often not explicit (see table 5.4). For instance, 26 percent of this debt is related to arrears in the payment of military pensions, which are supposed to be financed directly by the government. No interest is recognized on this debt. Other sources of investments are hotels, resorts, and real estate, which capture 25 percent of reserves. The hotels and resorts are managed by administrative companies also owned by the SSF. Finally, the SSF has full ownership of companies operating in the sport garment, pharmaceuticals, and maintenance sectors. The managers report that the company in the sport garment business is not operating but that employee continue to be paid. Nonetheless, these companies represent less than 3 percent of total assets.

In Morocco, the public pension fund managers have a reasonable institutional capacity, but performance is compromised by the lack of independence from the government. The funds of the CMR are managed through an internal investment unit. This unit has three committees: (a) the investment committee, which provides the investment strategy based on the planned financial needs and market conditions, fixes the short-term investment objectives, and assesses performance; (b) the placement committee, which proposes the placement policy to the investment committee, implements the investment strategy, taking into consideration market conditions, and reports on performance; and (c) the supervisory committee, which assesses performance, controls the conformity of the implementation of investments with the strategy,
ensures compliance with prudential rules, and sends proposals on investment policy and strategy to the Ministry of Finance, if necessary. The unit has competent personnel, but intervention on the part of the Ministry of Finance has placed excessive restrictions on investments, including the use of these funds as a quasi-captive source of financing for the public sector. Indeed, the minimum requirement for investments in government securities recently was increased from 80 to 88 percent of the portfolio; the remainder can be invested in securities listed on authorized exchanges and in real estate. Ineligible assets, among others, are foreign assets, mortgages, bonds, and investment funds. The CMR uses acceptable exposure limits, which are 10 percent per issue or issuer.

The CDG manages the funds of the scheme for private sector workers (CNSS-Morocco) and the scheme for contractual workers (RCAR). The CDG has built an impressive structure, with highly qualified staff; however, it is not fully independent from the government, and its governance, accountability, and investment policy do not meet modern good practices. The CDG does not charge management fees on market-based investments (the RCAR and the CNSS-Morocco mutual funds). In the case of the deposit account with the CNSS-Morocco, which earns a fixed interest rate, it charges 0.7 percentage point. The CDG implements the investment policy of each fund through its own investment management unit. In 2002, it outsourced only DH 3 billion out of DH 30 billion in funds to two fund managers. It is not allowed to invest abroad and has one investment committee per portfolio. It uses its own fund managers and does not seek the advice of external experts or investors. The CDG participates in the shareholder general assemblies of the corporations in which it has invested. In addition, it is a dominant player in the securities market, which has the ability to discourage the participation of other institutional investors. The CDG holds about 25 percent of government bonds, 20 percent of corporate bonds, and 30 percent of mortgage bonds and represents only 5 percent of stock market capitalization (see table 5.5). This high concentration on the demand side could create

<table>
<thead>
<tr>
<th>Type of investment</th>
<th>Portfolio allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government bonds</td>
<td>25</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>20</td>
</tr>
<tr>
<td>Mortgage bonds</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: CDG.
uncertainties in market behavior and discourage the participation of private investors. Further uncertainties could result from the fact that the CDG is both the market maker for public debt and a fund manager.

**Improving the Management of Public Pension Funds: Constraints and Opportunities**

This section starts by examining some of the constraints that limit the ability of Middle East and North African countries to adopt the set of good practice principles for pension fund management outlined in this chapter. It then highlights areas where even marginal changes could lead to better governance and management. The chapter closes with specific recommendations regarding investment opportunities.

**Limitations on Better Governance and Better Management**

In order to make realistic recommendations to improve governance and management in the Middle East and North African countries, it is important to understand local institutional and economic constraints. These constraints come from four main sources: (a) a legal framework that makes the application of best-practice models difficult, (b) governance problems at the macro level, (c) limited administrative and institutional capacity, and (d) the level of development of financial markets. These are discussed below.

A first observation is that the best-practice models and principles for improved management and governance have limited applicability in Middle East and North African countries because they were constructed based on the experience of developed countries founded on a legal system of English common trust law. The principles discussed in the previous sections are based on practices observed in countries like Australia, Canada, Ireland, New Zealand, the United Kingdom, and the United States, where the implicit responsibilities of the trustees for supervision and good conduct stem from the very nature of English trust law (see Clark 2004). The actions of the trustees and their ability to take on responsibilities with discretion are crucial to the efficient provision of pension benefits. Because code law traditions prevail among Middle East and North African countries, the behavior and responsibilities of trustees have to be codified. This process is inefficient and hinders improvement of accountability and other governance processes.

A second observation is that progress on pension fund governance needs to build on the level of governance in the whole economy, which remains weak for the region. Most of the principles of good governance,
accountability, and investment policy involve clear, high-quality rules and regulations to enforce good behavior, control corruption, limit government interference, and ensure proper accountability.

Since the management of pension funds in Middle East and North African countries is heavily linked to management in the public sector, applying these principles successfully depends to a great extent on political stability, accountability, effective government, regulatory quality, control of corruption, and enforcement of the rule of law throughout the economy. These factors are considered to be the main indicators of good governance for the economy as a whole (see Kaufmann and others 2003). Evidence suggests that many Middle East and North African countries are located on the lower end of the international distribution on most indicators (see figure 5.5). Therefore, rapid progress toward better governance in pension fund management is limited in the context of political instability, low accountability, and poor regulatory quality.

**Figure 5.5 Governance Indicators in Middle East and North African Countries: Voice, Accountability, and Regulatory Quality, 2002**

<table>
<thead>
<tr>
<th>Voice and accountability</th>
<th>Regulatory quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morocco</td>
<td>United Arab Emirates</td>
</tr>
<tr>
<td>Jordan</td>
<td>Bahrain</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>Oman</td>
</tr>
<tr>
<td>Qatar</td>
<td>Qatar</td>
</tr>
<tr>
<td>Lebanon</td>
<td>Jordan</td>
</tr>
<tr>
<td>Oman</td>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>Djibouti</td>
<td>Morocco</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Tunisia</td>
</tr>
<tr>
<td>Tunisia</td>
<td>Egypt, Arab Rep. of</td>
</tr>
<tr>
<td>Egypt, Arab Rep. of</td>
<td>Lebanon</td>
</tr>
<tr>
<td>Yemen, Rep. of</td>
<td>Algeria</td>
</tr>
<tr>
<td>Algeria</td>
<td>Yemen, Republic of</td>
</tr>
<tr>
<td>Iran, Islamic Rep. of</td>
<td>Djibouti</td>
</tr>
<tr>
<td>West Bank and Gaza</td>
<td>Syria</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>Syria</td>
</tr>
<tr>
<td>Syria</td>
<td>Libya</td>
</tr>
<tr>
<td>Libya</td>
<td></td>
</tr>
</tbody>
</table>

Source: Kaufmann and others 2003.

Note: The governance indicators presented here reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen, and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, nongovernmental organizations, and international organizations. Countries’ relative positions on these indicators are subject to margins of error that are clearly indicated. Consequently, precise country rankings should not be inferred from these data.
Finally, there are economic constraints, the level of development of financial markets being a critical one. As pointed out in chapter 2, debt instruments and publicly traded equity instruments are available in most Middle East and North African countries, but the supply is limited. Stock exchanges exist in most countries reviewed in this report, but financing through the stock exchange is marginal, and the number of listed companies is very small. The insurance industry, and in particular the life segment, remains small in most countries.

These incomplete or shallow financial markets pose an additional constraint on good governance because they limit the availability of appropriate structures for outsourcing pension administration functions to independent and qualified third parties. For example, management of pension assets cannot be outsourced to private parties such as specialized securities or equities trading companies because such institutions do not exist or are in an incipient stage of development. Furthermore, experienced trustees and pension professionals are in very short supply even in developed countries, and systemic problems of asymmetrical information and moral hazard work against the efficacy of pension fund governance in all countries (see Clark 2004; Myners 2001).

Opportunities for Better Governance and Better Management

Even in the context of the limitations discussed earlier in this section, there are real opportunities for all the Middle East and North African countries to improve the governance and management of their pension systems. The main argument is that, in the absence of drastic changes to governance structures, reforms over the short term should focus on (a) improving transparency, which involves mandating pension funds to fully disclose their operations; (b) building technical capacity to design investment policies and reducing constraints on investments; and (c) where possible, promoting the outsourcing of fund management. Practical recommendations in each of these areas are offered below.

Transparency

Governance of public pension funds in the region could be improved by increasing transparency of management processes and stakeholder access to information. These objectives could be achieved by combining several measures, as follows.

First, public pension funds should issue formal mission statements to focus the functional mandate of the scheme and explicitly list the categories of actions that would accomplish this mandate, while promoting the best interests of stakeholders. Even if a mission statement does not have immediate practical implications, it would significantly improve
transparency because it states explicitly the connection between the interests of stakeholders and the mandate and role of administrators in pursuing them.

Second, it is desirable to review internal regulations or procedures in order to define clear responsibilities and benchmarks for each of the three main functions performed by a pension fund: administration (that is, collection of contributions, custody of assets, and protection of contributions); determination of benefit eligibility; and management of assets. This potentially could be achieved, even in countries where governance bodies are not separated from management bodies, by making use of internal committees, specialized in the main functional activities of the fund. This could significantly improve the accountability and transparency of management processes. An example to that effect is the CMR in Morocco, where operations are managed internally by different committees with specific functional responsibilities, specified in detailed internal regulations. The draft law on public pensions in the West Bank and Gaza is another example of the use of specialized committees as a tool for improving transparency and efficiency of the management processes for public pension assets. The draft law mandates the establishment of an audit committee and an investment committee, with detailed responsibilities and reporting requirements (see box 5.1).

Third, transparency and stakeholder access to information could be improved by setting up a routine of standardized reporting to all stakeholders and to the supervisory and regulatory entities. Basic reporting requirements within the pension fund include annual financial reports prepared by the management entity for the board of directors of the pension fund; internal audit reports of accounting and asset valuation procedures, giving preference to market or mark-to-market procedures; audit reports prepared by external, independent auditors for the managing entity; and investment reports prepared by the investment entity for the managing entity. Disclosure of information to members is also very important. In the Middle East and North Africa region, there is much room for improvement in this area, since mandatory reporting is scarce.

Finally, transparency and governance would improve if countries would put management processes under mandatory supervision by a third-party entity. Best-practice examples delegate authority for supervision either to specialized entities or to financial market supervisors, such as the central bank, insurance supervisor, or security market supervisor. Delegating supervisory authority to the financial market supervisor would be most advisable for Middle East and North African countries because it would draw on existing technical capacity in these institutions
Provisions of the Draft Law on the Public Pension Scheme in the West Bank and Gaza

The West Bank and Gaza has an ambitious draft law for the public pension scheme that dedicates an entire chapter to governance and management of pensions. The provisions proposed by this draft law are in line with international best practices in pension fund governance and management. According to the draft law, the pension fund will have a multipartite board of directors that is nominated by the prime minister, at the recommendation of an independent nomination committee that is multipartite as well. There are clear provisions regarding the obligations and responsibilities of the members of the board of directors, including the obligation to adopt an investment policy. Management of the pension fund will be undertaken by a general manager, who will oversee implementation and management of individual accounts for participants, accounting of contributions and benefits, and reporting to participants and the governing board. The draft law states expressly the annual obligation to prepare detailed financial reports for the board and to undertake actuarial valuations every two years. An audit committee and an investment committee will carry out the regulations and functions stipulated by the law.

The main responsibilities of the audit committee are as follows: (a) oversee the selection process for an independent external auditor and recommend an auditor for appointment by the board, (b) order that an audit be performed at the end of each financial year, (c) receive and review the audit report and accompanying financial statements, (d) discuss with the auditor the methodology used and the findings, (e) present a report to the board on the results of the audit and a letter to management, (f) make recommendations to the board for improving weaknesses in accounting and associated internal controls, and (g) review the activities and results of the internal auditor quarterly.

The main responsibilities of the investment committee are as follows: (a) oversee development of investment guidelines for consideration by the board, (b) recommend investment options for consideration by the board, (c) oversee the criteria for selecting a custodian and asset manager and make recommendations regarding their appointments, (d) undertake quarterly reviews of portfolio allocations and investment returns using appropriate indicators of performance, and (e) periodically review the asset management operations of the fund.

The assets of the pension fund are entrusted to an independent custodian that has at least 15 years of experience and is licensed within the jurisdiction of an internationally recognized regulatory authority of well-established and widely acknowledged expertise as a supervisory agent. Investment of assets is done by an asset manager that is subject to similarly strict criteria and has to comply with a full disclosure policy regarding fees and transaction costs. These requirements ensure that the custodian and the asset manager are recognized international institutions with substantial experience in the field.

These new legislative efforts seek to reform weak governance structures that lack internal resources and infrastructure. The success of implementing the draft law remains to be seen, but the effort to devise a solution to improve governance and management is commendable.
and add an additional layer of protection against discretionary interventions of the government. Jordan, Morocco, and Tunisia could make significant progress in this direction since they have the opportunity to capitalize on the positive developments that have taken place in their financial markets with regard to growth of the banking sector and efforts to strengthen the financial regulatory environment (see chapter 2).

Progress toward implementing these measures could be achieved gradually within the existing framework, without a major redesign of the system providing retirement income. If successfully implemented, these measures would improve both internal and external transparency of the management process, therefore improving accountability and stakeholder voice. Such developments would reduce the opportunities for discretionary government interventions, directly addressing the most serious threats to governance for the countries in the Middle East and North Africa region.

**Capacity to Design and Implement Investment Policies**

Pension fund management could be improved by strengthening the capacity to design and implement investment policies and by defining explicit investment strategies. Investment strategies should be designed and executed by investment committees composed of qualified professionals, with the only objective being to benefit plan members. The SSIU in Jordan is a good example.

Investment committees should be able to assess the investment opportunities available in both domestic and international markets and tailor portfolio allocation to the specific characteristics of the pension fund they are advising. Expectations regarding targeted rates of return and risk exposure should be consistent with the interests of members and beneficiaries.

Pension funds should issue investment statements or policies that, given estimated future liabilities, define investment objectives and, in particular, the risk tolerance of the portfolio and the expected rate of return. Investment policies should include explicit standards and procedures regarding limitations on allowable asset classes, concentration of ownership, issuer, risk, and type of financial instruments. The focus must be on long-term investment and diversification. Investment statements could also prohibit unauthorized use of pension assets to finance budget deficits, lend funds to employees, or invest in various economic or social development projects. It is very important that the statement of investment policies define benchmarks against which the performance of investment policies can be evaluated.
Countries should also pursue opportunities to outsource the management of part of the funds. It is essential to promote outsourcing under contracts with clear investment strategies and benchmarks. Countries where management capacity is limited or not available at the local level (for example, Djibouti, Iraq, Libya, the West Bank and Gaza, and the Republic of Yemen) should consider foreign managers. Outsourcing should be pursued through public bids, and the funds should monitor outsourced fund managers and assess their long-term performance. The outsourced contracts could be terminated in cases where the contractor does not comply with the agreed upon conditions, including performance relative to benchmarks. In order to preserve market competition and transparency, no fund manager, including the in-house operation, should manage resources in excess of 5 percent of the country’s total financial resources (the aggregate of money, quasi-money, and bond and stock market capitalization). The funds should delegate the representation on corporate boards, including decisions on voting, to outsourced fund managers.

**Investment Opportunities**

These vary across countries, depending on the level of development of the financial sector (see chapter 2). In general, given poorly developed stock markets, the main sources of potential investments will continue to be (a) direct investments in companies, (b) loans to plan members, (c) public debt, (d) bank deposits, (e) real estate, and (f) foreign assets. Exceptions are Egypt, Jordan, and Morocco, where listed equities and collective investment schemes could capture between 15 and 30 percent of pension reserves. The main issues to consider when investing in these asset classes are as follows:

- **Direct investments in companies.** Direct investments can be risky, particularly when the funds have majority ownership and are involved directly in management (for example, Bahrain, the Islamic Republic of Iran, and Libya). Countries are encouraged to minimize this type of investment and certainly not to interfere with corporate governance: management of companies is not a function of pension funds.

- **Loans to plan members.** While most pension funds face strong pressure to offer loans to plan members (for instance, loans for housing), such loans entail high administrative costs and excessive risks to the system. Moreover, if public pension funds are to provide adequate income replacement for retirement, they should be exposed to a set of risks that are as different as possible from those that members face.
during their working life. Therefore, this type of investment should be discouraged. When it occurs, rules, including selection procedures, should be transparent, and no implicit or explicit subsidies should be involved.

- **Public debt.** Government debt continues to be an important component of the portfolio of most pension funds. This debt is not always explicit; it simply is related to arrears in contributions or loans that have not been documented properly (for example, Algeria, Djibouti, the Islamic Republic of Iran, and Libya). In all countries, the supply of treasury bills and tradable public bonds is low relative to the size of the total explicit government debt, and governments are encouraged to review the structure and maturity of this debt. Over the short term, an effort should be made to make explicit part of the implicit debt with the pension funds and to ensure that this debt is remunerated appropriately. Morocco, where the government recently issued tradable bonds to cover its debt with the scheme for civil servants and the military, is an example to follow. In countries without a core of sound banks (for example, Djibouti and the Republic of Yemen), explicit public debt is likely to be the most promising source of investment over the short and medium terms. In any case, public debt should not be imposed on pension funds. The demand for this asset class should respond to the objectives set in the statement of investment policies.

- **Bank deposits.** In countries with a core of sound banks (for example, Jordan, Lebanon, Morocco, and Tunisia), public debt can play a less prominent role, while long-term bank deposits capture the largest share of the nonequity portfolio. Clearly, in cases where the banking sector is overexposed to government debt, bank deposits will not be a substitute.

- **Investments in real estate.** Real estate investments are likely to remain important for most countries. These should not involve the management of hotels or office buildings but rather should focus on actual real estate. Because investing in illiquid assets creates opportunities for corruption, clear procedures for purchasing and disposing of these assets should be approved by the board. By the same token, independent assessors should value these assets at least once a year.

- **Foreign assets.** To improve risk diversification, pension funds should be allowed to invest part of their portfolio abroad (for example, in treasury bills or indexes). An interesting initiative in this area comes from the West Bank and Gaza, where a significant component of pension assets is expected to be invested abroad.
Conclusions

The region faces a compelling challenge in improving governance and management outcomes for public pension funds. Indeed, the examination of governance structures and management of public pension fund systems in the Middle East and North Africa region reveals a serious gap when compared with best international standards and practices for good governance and sustainable management.

However, structural constraints might continue to hinder progress. These include (a) a legal framework that makes the applicability of best-practice models difficult, (b) governance problems at the macro level, (c) limited administrative and institutional capacity, and (d) the level of financial sector development. Major changes in governance and administrative structures are unlikely to be feasible in the current context.

Nevertheless, there are encouraging stories. Recent progress in Jordan and the West Bank and Gaza in improving governance and management of their pension systems suggest that there are real opportunities to make changes that will have a large positive impact.

Governance overall would benefit significantly from increased transparency of management processes and stakeholder access to information. Feasible actions include mission statements, internal regulations that define management responsibilities, routine standardized reporting to stakeholders and regulators, and independent supervision of public pension funds.

Pension fund management could be improved by strengthening the capacity to design and implement investment policies. Countries need to invest in teams of qualified professionals to manage their pension funds. There should be clear guidelines for investment policies that, given estimated future liabilities, define investment objectives, including the risk tolerance of the portfolio and expected rates of return. Asset allocations should respect clearly defined exposure limits. In particular, pension funds should not be involved in the direct management of companies; in financial, economic, or social development projects; or in lending to plan members. Finally, there should be clearly defined benchmarks to evaluate investment policies.

Finally, countries should actively pursue outsourcing the management of part of the funds. Outsourcing contracts should be based on clear investment strategies and benchmarks. In countries where management capacity is limited or not available at the local level, foreign managers should be considered. Outsourcing should be pursued through a process of public bids. In order to preserve market competition and transparency, no fund manager, including the in-house operation, should manage resources in excess of 5 percent of the
country’s total financial resources. Funds should delegate the representation on corporate boards, including decisions on voting, to outsourced fund managers.

Notes

1. The only exception is the RCAR in Morocco.
2. All the issues and principles discussed in this section are based on Carmichael and Palacios (2004) and Musalem and Palacios (2003).
3. This is likely to change in Jordan, where the SSIU is reviewing reporting procedures.
4. A complete annual financial report should include the following: a balance sheet, a statement of revenues and expenditures, a statement of change in net assets, and a statement of investments.