Pensions Governance

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World Bank Core Course on Pensions

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### Pensions financing and governance models

<table>
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<th>Financing</th>
<th>Fund type</th>
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<td>PAYG</td>
<td>Public Pension Reserve Fund (PPRF)</td>
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<td><em>Funded arrangements</em></td>
<td><em>Pension Fund</em></td>
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<td><em>Provident Fund</em></td>
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The key difference between a pension fund/provident fund and a PPRF is that in the former there is a clear link between the assets and the liabilities, whereas in the case of a PPRF, there is rarely such a link (main exceptions: Canada and Sweden)
Financial Governance

- **Involves**: managerial control and organizational design of pension entities, as well as their external supervision

- **Goal**: minimize potential agency problems or conflicts of interest between the principal (beneficiaries and other stakeholders) and the main agent (governing board) and between the latter and delegated agents (e.g. investment manager)

- **Benefits**: increase value for stakeholders, in the form of improved investment performance (net of operating costs and adequate compensation for risk)

Good financial governance also creates trust among stakeholders and contributes to the efficiency and stability of the financial system
Financial governance in PAYG systems

- PAYG systems usually managed by a public, autonomous, not-for-profit entity ("social security institution")

- Board of such entities usually has tripartite representation

- Entity usually reports to Ministry of Labour/Social Affairs but also close links to Finance Ministry

- Actuarial evaluations to monitor the sustainability of pension system

- PAYG systems usually have some reserves that need to be invested
Role of reserve funds in PAYG systems

- Liquidity management
- Saving for a rainy day (e.g. demographic shock)
- Integral part of financing mechanism (partly funded schemes - e.g. Canadian and Swedish social security systems)

*Investment horizons and goals of these funds are very different*
Specific governance concerns of reserve funds

- Government as sponsor, regulator and supervisor (political risk enhanced)
- Do not have national competitors or peers
- Do not have readily measurable liabilities, as normally there is no funding target
- Public sector labour standards can make it difficult to attract suitably qualified staff to manage investments
- Multiple stakeholders, complicates determining the investment horizon and risk tolerance

The “governance challenge” is greater in reserve funds
Key aspects of legal form of reserve funds

- **Legal ownership of assets**
  - **SSRFs**: assets are part of social security scheme.
  - **NPRFs**: assets are legally separated from the social security scheme, they are direct government property.

- **“Ring-fencing”**
  - By law or statute, can assets be used only for payment of retirement benefits?

- **Fund administration**
  - Social security institution
  - Government ministry or central bank
  - Separate investment management entity

*Key to governance are ring-fencing and administration*
Advantages of separate investment management entity

- Can appoint experts to the board and management, attracting qualified investment professionals with competitive remuneration.
- More dynamic decision-making and management style possible.
- Clear mandate (maximise long-term returns), incentives (performance-based) and accountability (not concerned with contributions and benefits).
- Greater transparency of segregated fund governing body.
Examples of autonomous investment management entities

- **SSRFs**: Canadian Pension Plan Investment Board, Saudi Pensions Agency, Jordan Social Security Investment Unit

- **NPRFs**: National Pension Reserve Fund in Ireland, Australia’s Future Fund, New Zealand Superannuation Fund, Luxembourg’s FDC, Portugal’s Demographic Fund, Sweden’s AP funds, France’s FRR
Basic organisational structure of a reserve fund management entity

- Governing board (possibly dual, with a separate supervisory board)
- Management (headed by chief executive or equivalent)
- Investment committee
- Audit committee / internal auditor / compliance
Dual-board structure: France’s FRR

Minister of Social Affairs

Executive Board

Manager Selection Committee

Supervisory Board

Tripartite stakeholders

Appointment

Nomination

Consultation
The three pillars of good governance in reserve funds

ALIGNMENT OF INTERESTS & ACCOUNTABILITY

INDEPENDENCE, EXPERTISE & REMUNERATION

TRANSPARENCY AND EXTERNAL OVERSIGHT
1. Alignment of interests and accountability

- **Fiduciary duties of loyalty and care, conflict of interest rules**
  - Statutes of Canada’s CPPIB, Ireland’s NPRF and New Zealand’s superannuation fund all set out exclusive purpose is to serve beneficiaries.
  - Canada’s CPPIB is required to implement and disclose a *code of conduct*, including tight controls on the personal investing of directors and employees.
  - In **France**, **New Zealand** and **Ireland** board members must follow a code of conduct and must disclose any conflicts of interest they may have.

- **Clear goals and stable regulations**
  - Canada’s CPPIB states a funding ratio and rate of return target (and time horizon) in its statement of investment policy.
  - New Zealand Superannuation Fund aims at tax smoothing over a forty-year period (by law, government contribution rate linked to fund performance; no withdrawals before 2020).
  - The financial minister in New Zealand can give directions to the governing board of the Guardians of the Superannuation Fund but these must be in writing, must be presented to the Parliament, and must be published in the official gazette.
General principles of conduct (adapted from CFA Institute)

- Act in a professional and ethical manner at all times.
- Act in accordance with applicable laws, regulations and the fund’s own mission, rules and policies.
- Act with independence and objectivity (conflict of interest).
- Act with skill, competence and diligence.
- Disclose information to stakeholders in a timely and accurate manner.
- Maintain confidentiality of sensitive information.
Code of conduct: The French FRR

- Members of the Executive Board must submit and regularly update a statement indicating the interests and positions they hold in outside economic and financial concerns.

- They are barred from reviewing and voting on matters involving parties in which they hold (or have held in previous 18 months) a position, office or interest.

- They must notify in writing the chairman of the Supervisory Board and fellow members of the Executive Board whenever a potential conflict of interest situation arises.

- They are held to a strict obligation of confidentiality.
Conflicts of interest rules: The Irish NPRF

"Commissioners and members of the staff of the manager or committee must disclose to the Commission (or manager or committee) any pecuniary or beneficial interest in and material to any matter considered by the Commission" (Section 12(1), NPRF Act, 2000)

- Can neither influence nor seek to influence a decision to be made in relation to the matter
- Can take no part in any consideration of the matter
- Where relevant, must absent himself/herself from the meeting or part thereof during which the matter is discussed
- Where relevant, cannot vote on a decision relating to the matter
2. Independence, expertise and remuneration

**Independence**
- Two-stage nomination process for reserve fund board members in Canada and New Zealand
- Canada’s CPPIB board members have three-year appointments and can only be dismissed for illegal or immoral conduct.
- New Zealand Guardians of Superannuation board members can only be dismissed for reasons relating to their performance as members, or because of misconduct.

**Expertise requirements**
- Canada’s CPPIB board members must have an investment professional accreditation, experience as CFO, treasurer or pension consultant.
- In New Zealand, at least 4 members of the nominating committee must be inv. professionals. The fund’s board members must have experience and expertise in inv. management.
- Irish NPRF commissioners must have expertise and experience in investment, economics, law, actuarial practice, etc.

**Remuneration policies**
- Competitive compensation in funds such as Canada’s CPPIB has attracted high quality board and staff. CPPIB also has performance-based remuneration (4-yr, relative to target).
Dual nomination structures: Canada’s CPPIB

Finance Ministers from 9 provincial governments

Federal Finance Minister

Board of Trustees, CPPIB

Nominating Committee

Appointment
Nomination
Consultation
Dual nomination structures: New Zealand

Minister of Finance

Board of Trustees, Guardians of the Superannuation Fund

CEO

Parliament

Nominating Committee

Appointment
Nomination
Consultation
3. Transparency and external oversight

- **Independent audit**
  - In Canada, the CPPIB must appoint an external custodian and is subject to an annual financial audit by an external auditor, and every six years there is a special examination of investment practices.
  - In Ireland, annual audit by Comptroller and Auditor General

- **Disclosure**
  - The Canadian CPPIB and Irish Pension Reserve Fund are required to publish statement of investment policy, governance structure, quarterly financial statements (Canada’s CPPIB only) and annual reports (including performance assessment).

- **External monitoring**
  - Government, parliament, or the same authority that supervises private pension funds (e.g. Chile, Costa Rica, Indonesia, Kenya and Morocco).
Good governance is not enough to ensure good performance

You need also...

- Sufficient scale to:
  (i) afford good staff and systems,
  (ii) drive down unit costs; and
  (iii) seek investment opportunities

- Sensible investment beliefs and risk management

- Appropriate regulations

*Effective pension fund organisations achieve at least 1% higher risk-adjusted returns (Keith Ambachtsheer)*
It’s possible to reform public pension reserve funds!

- 1998: reform of the Canadian Pension Plan governance (establishment of Canadian Pension Plan Investment Board)
- 1998: reform of the Korea National Pension Fund (establishment of Fund Management Centre)
- 2001: reform of Jordan’s social security governance (establishment of Social Security Investment Unit)
- 2011-12: review and possible reform of Swedish AP funds
But at times of crisis all bets are off...

- Irish NPRF directed to bank recapitalisations.
- Norwegian GPF used for fiscal stimulus purpose.
- French FRR will be depleted earlier than planned to cover social security deficits...
- Untouched survivors in those countries were the crisis was less severe (e.g. Australia, Canada, New Zealand)

- Canadian CPP Fund may be strongest placed to weather crisis because:
  1. it is by law a partly funded scheme, not a temporary reserve – an automatic contribution/benefit adjustment mechanism is set off if actuarial imbalance
  2. funding from surplus of social security financing, not discretionary government funding (pensioners’ money!)
  3. high degree of independence and accountability
Possible challenges in developing countries and how to tackle them

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<tr>
<th>Potential challenge</th>
<th>Possible solution</th>
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| Political influence       | • Strict fit and proper requirements  
                            • Dual nomination process  
                            • Dismissal “for cause” only  
                            • Management staff (incl. CIO) chosen by board  
                            • Introduce funding ratio target in the law |
| Corruption                | • Code of conduct, conflict of interest rules  
                            • Supervision under state comptroller and pension fund supervisor |
| Small size                | • Introduce funding ratio target  
                            • Fiduciary manager  
                            • Passive investment strategies |
| Insufficient expertise    | • Foreign experts  
                            • Training |
### Appendix: governance in funded pension arrangements (public or private)

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<th>Type</th>
<th>Country examples</th>
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<tr>
<td><strong>Centralised and hybrid administration systems</strong></td>
<td>Denmark (ATP – hybrid), Sweden (PPM - DC), UK (NEST – DC), Kosovo (KPT - DC), Singapore (CPF - hybrid)</td>
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<tr>
<td><strong>Company-based and industry-wide arrangements</strong></td>
<td>Netherlands (DB), Sweden (DB), Hong Kong – China (DC), Australia (DC), Finland, (DB), Switzerland (DB/DC), Iceland (hybrid)</td>
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<tr>
<td><strong>Retail / personal arrangements</strong></td>
<td>Australia, Colombia, Chile, Mexico, Peru, Hungary, Estonia, Slovak Rep., etc (all DC)</td>
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OECD Guidelines on Pension Fund Governance

- First issued in 2001
- Approved as an OECD recommendation in 2005
- Reviewed in 2008, approved in June 2009
- Input from 37 governments and supervisors, private sector consultation
- Dovetails OECD Principles of Corporate Governance
OECD Guidelines on Pension Fund Governance

I. Governance Structure

“The governance structure should ensure an appropriate division of operation and oversight responsibilities, and the accountability and suitability of those with such responsibilities.”

- Identification of responsibilities
- Governing body
- Expert advice
- Auditor / Actuary / Custodian
- Accountability
- Suitability
II. Governance Mechanisms

“Pension funds should have appropriate control, communication and incentive mechanisms that encourage good decision making, proper and timely execution, transparency and regular review and assessment.”

- Internal Controls
- Reporting
- Disclosure
- Redress
Some lessons from pension fund governance

- Company-based / occupational arrangements:
  i. Value of paritarian representation need not be at the expense of informed boards
  ii. Fit and proper standards to be assessed, respectively, at the aggregate board and individual level
  iii. Power of licensing/certification in raising standards and consolidating industry

- Fees and misaligned incentives are the biggest governance challenge in retail/personal arrangements

- Political influence is the biggest governance challenge in centralised administration