



Social Policy Highlight 05



Social security funds: Investing for the future

Today's generalized concerns about financial sustainability, rising operating costs and the adequacy of benefits dictate the need to optimize social security fund investments. In turn, this need emphasises the necessity of appropriate government regulation. However, differences in national economic and financial market development imply that social security schemes' investment opportunities and priorities vary. With these issues to the fore, this *Highlight* reports on good practice developments in social security investments.

Hans-Horst Konkolewsky, Secretary General

The challenge of ensuring adequate longer-term financing for social security sits high on many national agendas. Measures to address this include efforts to slow down the growth in benefit costs, to reverse the (early) exit of older workers from the labour force and to encourage the non-employed to return to suitable work. In turn, streamlining social security's administrative costs and improving contribution collection have a role too.

To further ensure healthier financial in-flows, the tapping of innovative financing or tax sources is equally important. One further response is to optimize public social security fund investments. With regards to promoting good practice in the latter, the ISSA is playing a leading role.

Most notably, the ISSA has set the international benchmark by publishing *Guidelines for the investment of social security funds*.¹

Why the need for investment guidelines?

The ISSA investment guidelines are triply important. First, with the heightened requirement for transparent and accountable public institutions, the guidelines should help social

This issue:

- Discusses how investment guidelines aim to contribute to social security's sustainability
- Pinpoints challenges to optimizing social security investments
- Outlines the policy dilemma of satisfying the investment needs of social security and the national economy

security schemes maintain the soundness of their investment function. Second, that such guidelines have been developed by social security investment specialists is vital, not least to better ensure social security outcomes. Third, with the trend towards a greater use of benefits pre-funding, and with the number of national reserve funds growing,² there is mounting demand for good practice knowledge in social security fund investment. In 2005, the combined reserves of just twenty ISSA member organizations equalled US\$ 3.5 trillion!

Investment objectives

As defined by the ISSA *Guidelines*¹, there are two primary objectives for the investment of social security funds:

- Security – investments should help social security schemes meet their core commitments, and do so cost-effectively
- Profitability – investments should achieve maximum returns, subject to acceptable risk.

In practice, investments should seek to realize a suitable balance between these two objectives. And matching the projected liabilities of the social security scheme should take into consideration the scheme's maturity and shorter-term liquidity requirements – for example, by using liability-driven investment or other benchmarking techniques.

Social and economic investments

Once both primary objectives have been addressed, social security funds may also be harnessed for social and economic investment (SEI) objectives. This investment path is normally given preference by developing countries with insufficient access to alternative sources of development finance. Typically, investments are made in national infrastructure, low-cost housing, healthcare facilities, as well as in strategic sectors of the national economy.

Attitudes towards SEI are often polarized: They may be justified on the basis of their social rate of return or criticized on the basis of imputed suboptimal returns and market interference. Even so, there is no conclusive evidence that SEIs perform less well than conventional investments. Nevertheless the volume of SEIs in many portfolios is decreasing. Although controversial, this trend may not be positive in all cases. Specifically, this may constrain developing countries' efforts to successfully emulate the national development paths of earlier developmental states.

To explain the decline in SEIs, one can identify the current primacy given to political transparency and accountability and pressures to reduce unfunded liabilities by amassing assets to meet obligations. It may also reflect a more generalized fall in direct government influence over specific investment choices.

Regardless of diverging opinions on government's appropriate investment role, it is inconceivable that government will distance itself entirely from social security investments: Appropriate government regulation is vital. And this fundamental role is underlined by a growing vested interest among developed country governments to keep abreast of socially responsible investing.

Governance structures and mechanisms

The necessity of having sound governance structures and mechanisms is one area for which there is firm agreement. For instance, good practice advocates that responsibilities for enforcing operational and regulatory oversight should be kept separate. And due care must be taken to guarantee the suitability of those appointed to hold such responsibilities.

Generally there are two institutional settings for administering social security fund investments. The investing institution may be either the entity administering the social security scheme or an entity established expressly to invest the scheme's funds.

In both cases, the respective governing body has a duty to appoint an investment committee responsible for developing the investment policy as well as the investment strategy by means of which this policy will be realized. And to promote accountability – as well as to reduce investment risk perception – there is an expectation that all relevant information should be publicly disclosed to all stakeholders.

Investment policy and strategy

Subject to national capacities, the investment policy of a social security scheme may be based on prudent person principles. And the investment strategy should take into account any quantitative restrictions which apply to the minimum or maximum allocation of investments in specific assets or classes of assets. Such restrictions are usually outlined in the social security scheme legislation, in ministry of finance or central bank directives, or imposed by the responsible governing body.

Although schemes' fund sizes and investment needs vary, the sophistication of a scheme's investments will always be constrained by the relative institutional capacities and depth of its domestic market to absorb such investments. In some cases, this may result in liquidity problems. Specifically, thin domestic markets generally provide too few opportunities to match funds with productive investments.

This begs the question: in all cases, is the build-up of sizeable social security funds sensible if these cannot be productively invested?

Foreign investments

One answer to this question is for countries with thin domestic financial markets to place funds in foreign investments. As argued, foreign investments should provide more opportunities to match assets and liabilities, and they should also provide higher and more predictable returns. Moreover, foreign investments can help better achieve requirements for diversification and the control of investment risk.

However things are never that simple. The counter argument is that foreign investments represent a missed opportunity for developing the national economy, since they reduce investments in the domestic goods, services, and jobs required to pump-prime consumer-driven growth.

But for many schemes this dilemma is hypothetical: regulations forbid foreign investments. Yet even when permitted,

the home bias in many schemes' investments suggests a more generalized reluctance to invest abroad.

In practice, significant foreign investment portfolios are found only in more advanced and small-island countries. In some cases this may be because very big domestic funds can no longer be optimally placed even in well developed local financial markets.

Good investment practice

Imprudently or improperly invested funds can yield negative real rates of return or can disappear altogether.¹ So with the continuing build-up of social security funds, social security schemes have a heightened responsibility to ensure that funds are appropriately regulated, managed, and invested.

To this end, and aligned with central bank objectives, the investment policy should address the following five points:

Risk management – The degree of risk that a scheme can sustain must be determined. This requires a sound understanding of the scheme's obligations and the purpose of its investments.

Diversification and dispersion – Schemes should hold an appropriate mix of assets in order to ensure financial sustainability.

Matching assets with the duration of liabilities – Investments must be consistent with the financing objective of the scheme and its cash-flow requirements.

Currency matching – Although foreign investments should be limited to appropriate securities, schemes have a responsibility to manage currency risks.

Performance measurement and monitoring – Investment performance in the accumulation and pay-out phases should be monitored and assessed against target return rates and benchmarks.

Investing for the future

Social security funds and their investment income safeguard the ability to pay promised benefits and provide services. And in many countries reserve funds are also being set aside to meet projected future costs. Yet for many social security schemes a pressing challenge is to attract staff with the requisite fund management skills. With the market normally offering more lucrative employment packages, this challenge cannot be overstated.

Regarding the future optimization of fund investments, ISSA research shows that many social security schemes are seeking additional good practice knowledge with regards to:

- Improving financial literacy and financial market knowledge
- Strengthening financial risk management
- Achieving better returns, subject to acceptable risk
- Investing abroad without destabilising the domestic market
- Delimiting government's optimal regulatory and investment roles.

Sources

¹ ISSA. 2005. *Guidelines for the investment of social security funds*, ISSA, Geneva. Available at: <http://www.issa.int/pdf/general/2Merida-Guidelines.pdf>.

² ISSA. 2007. *Public Scheme Reserve Funds: Helping sustain PAYG pensions*, ISSA, Geneva. Available at <http://www.issa.int/pdf/publ/2surveyreport.pdf>.

The **International Social Security Association (ISSA)** is the world's leading international organization bringing together national social security administrations and agencies. The ISSA provides information, research, expert advice and platforms for members to build and promote dynamic social security systems and policy worldwide.

4 route des Morillons
Case postale 1
CH-1211 Geneva 22

T: +41 22 799 66 17
F: +41 22 799 85 09
E: issacomm@ilo.org | www.issa.int