



issa

INTERNATIONAL SOCIAL SECURITY ASSOCIATION
ASSOCIATION INTERNATIONALE DE LA SÉCURITÉ SOCIALE
ASOCIACIÓN INTERNACIONAL DE LA SEGURIDAD SOCIAL
INTERNATIONALE VEREINIGUNG FÜR SOZIALE SICHERHEIT

Regional Social Security Forum for Asia and the Pacific

Manila, Philippines, 21-23 October 2009

Governance and the social security reform process

Yvonne Sin

Head of Investment Consulting, China

Watson Wyatt Investment Consulting Hong Kong Limited

Hong Kong, China

Governance and the social security reform process

Yvonne Sin

Head of Investment Consulting, China

Watson Wyatt Investment Consulting Hong Kong Limited

Hong Kong, China

1. Introduction

A successful social security system has important implications for a nation's economic development, social harmony and political stability. Many countries have taken the initiative to reform their social security programs with a view to building a stronger foundation for tomorrow's growth. More than many other social security issues, the subject of pensions is drawing a great deal of attention from reformers. With continued population aging, longer life expectancies, worsening elderly dependency ratios and escalating pension costs, the reform of pension systems will likely remain a high priority item in the foreseeable future.

Over the past decade, an increasing number of countries recognized the seriousness of the impending aging crisis and began to partially prefund their otherwise pay-as-you-go (PAYGO) financed national pension systems. They also created public pension reserve funds so that the systems would be more likely to meet their obligations. As a result, pension assets have been growing and stakeholders are interested not only in protecting but also in adding value to the accumulated funds. In order to achieve this, a disciplined approach based on sound governance principles throughout the asset management cycle is critical.

According to Sin and Zhang (2009a) (2009b), the recent global financial crisis added a new urgency to debates on improving pension governance in general. They reviewed data from various sources including the Organization for Economic Co-operation and Development (OECD) and Watson Wyatt's own research, and observed that public pension funds were more adversely affected. Following the failure and the need for bailouts of a number of large financial institutions, the market value of assets shrank severely and many public pension reserve funds began earning negative returns. To make matters worse, the economic slowdown unleashed by the subprime crisis led to increased strains on public finances, rising unemployment and falling tax receipts, at a time when additional contribution revenues might be required for shortfalls in meeting benefit disbursements. These developments coincided with a period of intense pressures on the government to respond with stimulus packages, currency stabilizing plans and other measures. It soon became apparent that any delay in efforts to counter this domino effect could aggravate the fiscal and solvency repercussions. The authors suggested that better governance structures, clearly defined roles and responsibilities as well as greater transparency in fund management would help protect pension assets from suffering further losses.

Noting that the performance of pension funds appears to be a burning issue that involves large accumulations of assets, this paper will present aspects of mainstream thinking for positioning governance in relation to pension fund development, from which lessons can be

drawn and applied to the social security context. Selected findings and cases will be used to provide perspectives for further reflection.

2. Governance – Principles, structures and functions

The subject of governance is a complex one and a lot has been written about it in association with various disciplines and fields of work. A sufficiently flexible working definition may be offered by the following: “Governance refers to the systems and processes by which a company or government manages its affairs with the objective of maximizing the welfare of and resolving the conflicts of interest among its stakeholders” (Carmichael & Palacios, 2004). Whether it is being considered a highly institutionalized decision management mechanism or an elaborate system of rules, checks and balances for preventing the manipulation of decision-making processes, the notion of governance is increasingly being associated with fund management.

Broadly speaking, the benchmarks of good governance revolve around the principles of role clarity, accountability, transparency and independence from government. Although there is no one protocol that is universally accepted as the gold standard of good governance, useful guidelines for setting up structures and mechanisms are provided by international organizations such as the International Social Security Association (ISSA) and the Organisation for Economic Co-operation and Development (OECD). According to ISSA guidelines, a sound governance structure must provide for an appropriate division of operational and oversight responsibilities as well as ensure the suitability and accountability of those who are responsible. In addition, there should be effective control, communication and incentive mechanisms to encourage good decision-making and transparency (ISSA, 2004).

The primary purpose of institutionalizing governance in fund management, including the management of pension plan and social security program assets, is to ensure that members and beneficiaries receive the promised protection from the respective schemes. Ultimately, this translates into making sure that the pension or social security system is sustainable over the long-term. However, governance of public funds faces special challenges – there may be agency, ownership or stakeholder identification problems; they are generally more vulnerable to political intervention; it is often difficult to measure and monitor performance in the public sector; and they often lack a sufficiently developed investment culture. As social security establishments accumulate more assets, the ability to properly manage the investment of social security funds becomes an increasingly important function of public sector governance. In recent years, the role of investment governance in asset management – managing risk, controlling costs, maintaining solvency and achieving superior long-term results – is becoming a major focus of attention for sponsors of pension funds and other social security programs.

The relationship between governance and fund performance has been examined by researchers. Iglesias and Palacios (2000) compared annualized returns of publicly-managed pension funds with bank deposit rates and real income per capita growth in selected countries. The bank deposit rate was used as a crude benchmark for normalizing country-specific factors and for helping to assess investment efficiency against available investment alternatives in the respective countries. The relationship between real income per capita growth and investment returns directly impacted the replacement rate that could be achieved upon the retirement of plan members. Although calculation periods varied across countries because of differences in data availability, the results consistently demonstrated unsatisfactory performance in the case of public pension fund management. Further comparison showed that private pension funds were able to generate far better investment results. For example,

private pension funds in Sweden and Japan earned returns that were 300 and 500 basis points higher respectively compared with their public sector counterparts over the long-term. The authors explored potential explanations for the performance discrepancy and suggested that governance was an important factor, apart from risk profile, investment restrictions and data quality issues.

Other experts have commented on how better governance can lead to better investment outcomes. Ambachtsheer (2006) believed that pension funds should build a high-performance investment culture and that this would make a difference to the financial performance of the funds. He considered a number of governance issues particularly relevant for creating the right kind of environment that would make this possible. These include: agency or context issues that are concerned with balancing stakeholder interests and understanding the legal/regulatory environment; governance effectiveness issues that include an appropriate skill/knowledge set for the board and clear delegation to management; risk management issues that involve understanding context-based risk and its management; informed investment beliefs and their relevance as well as shifting to a budget-based investment process. In “Pension Revolution: A Solution to the Pensions Crisis”, Ambachtsheer (2007) demonstrated a “governance shortfall” (defined as the return foregone due to internal governance and management problems) of 100 to 200 basis points per annum between good and bad governance from his database of funds.

The literature on governance as it relates to public pension assets is relatively new but interest in the field is growing rapidly. Writing about financial governance and risk management, Daykin (2004) indicated that a sound governance structure is essential for the effective investment of social security funds as they may have assets comparable to or larger than many financial institutions. He maintained that risk management should be integrated into the financial governance structure to address the broad range of liabilities that social security schemes may be exposed to. In his review of governance and the investment of public pension reserve funds, Yermo (2008) underscored the importance of good governance and investment management and advocated reforms to bring about additional governance safeguards that would improve long-term investment performance and protect funds from political interference.

In countries with different legal, fiduciary and cultural legacies, references to governance may not be as explicit as in many western countries. This does not mean, however, that governance issues are not being addressed in reforms that are taking place in those countries. Publications about these developments are more apt to be found in what may be considered grey literature. Thus, in “Understanding China’s Pension System: Yesterday, Today and Tomorrow” (Sin, 2008), various strategies proposed for a new generation of reforms were based on the fundamentals of good governance. Although the word governance itself was not used, the recommendations called for efforts to “align risk and return with investment goals in accordance with modern techniques of portfolio management and fund investing”, and to build “a standardized and effective supervisory and reporting system to protect fund accumulations”.

Regardless of whether it is explicitly articulated or incorporated into the language of reform, the role of governance appears to be gaining prominence in the discourse on pension system reform around the world.

3. International best practices and models

Given that the governance of public pension funds is still an emerging field, documentation of best practices on aspects of governance pertaining to social security schemes alone is not

widespread. Instead, reviews or case studies on pension management best practices where governance is considered an important element will be used to reflect some of the current thinking in relation to what standards institutional investors should care about. The two bodies of work discussed below bring different perspectives of best practice analysis and offer a useful frame of reference for thinking about the design and implementation of governance measures in the social security reform process.

Halpern and Irving (2004) underscored the emergence of best practices in institutional investment based on the experience of a collection of various bodies in managing investment portfolios. They believe that true best practices evolve out of a focus on fiduciary responsibility. Best practice standards define the responsibilities or powers of groups such as the board, trustees, committees, plan sponsors, staff and external providers, and govern relations and controls between them involving delegations of authority, rules of order, lines of reporting, education and training and other processes. A written investment policy statement must document governance provisions in the context of a holistic management philosophy that typically includes the use of asset liability modelling, risk return analysis, investment manager selection and performance monitoring. Sources of stress for public funds are deemed to arise mainly from the relationship of the board to the sponsoring government as well as the improper influencing of board decisions for political reasons. Disclosure of requirements and adherence to disciplined processes are considered helpful for mitigating these problems.

The “Oxford-Wyatt Project on Governance” (Clark and Urwin, 2007) examined a diversity of funds (including corporate pension plans, public pension plans, sovereign funds and endowment funds) spread across different regions (Asia-Pacific, Europe and North America), where the application of governance principles went hand in hand with strong performance. Best practices are seen as important tools that not only help institutions adapt to the realities of the global marketplace but also contribute to the success of reforms over the long-term. Using a social science case study methodology that relied heavily on qualitative considerations, the researchers teased out best practice principles and organized a resource-based framework that institutional investors can adopt.

The Clark/Urwin study on best practice governance (Watson Wyatt Worldwide, 2007) identified twelve governance-related characteristics that cover three domains – organizational coherence, people and process. Six of these are considered core attributes that should be well within the reach of most funds and six are considered exceptional attributes that represent a higher degree of excellence that funds can aspire towards. Under organizational coherence, best practice starts with clarity of mission and appropriate alignment with budget resources, and can advance to the creation of a highly competent investment executive function. Best practice people factors range from a minimum of leadership skills to high level board competencies that include numeric skills, logical thinking and an aptitude for risk and probability analysis, as well as supportive compensations that attract and retain talents. For process factors, core attributes include strong investment beliefs, a properly aligned risk budget and a fit-for-purpose manager line-up, while exceptional attributes allow for competitive positioning, real-time decision-making and working with a learning culture.

The “123 model” proposed in the study uses the concept of a governance budget – defined as a combination of time, expertise and organizational effectiveness – to think about how to exploit different investment opportunities according to the level of resources available. Thus, funds with the least governance resources should spend less time on the lower impact area of monitoring managers and leave more time for asset allocation decisions where the impact is greater. Funds with medium range resources should be able to pursue some value creation opportunities, consider improving asset diversity beyond traditional equities and bonds, and add on a limited amount of active management. At the high end, funds with resources to

engage the services of investment experts would be in a position to adopt the exceptional attributes and take on greater diversity as well as a higher proportion of manager risk. For funds experiencing short-term constraints but are committed to improving governance in the near future, there is the option of either building up or outsourcing the executive function. The key would be to strike a balance between the desired level of best practice on the one hand and available resources and material constraints on the other.

In the complex and competitive world of institutional fund management, it may not always be easy for a fund to stay on track when caught up in crisis-type situations. An example of this would be the recent global financial crisis and how it affected some high profile public pension funds with an international reputation for having high standards of transparency and accountability. Three such schemes were presented as “good models” at the Second Public Pension Fund Management Conference hosted by the World Bank (Maher, 2004), namely the Irish National Pensions Reserve Fund, the Norwegian Petroleum Fund (now known as Norway’s Government Pension Fund--Global), and the Canada Pension Plan Fund. It would be instructive to see what happened with these funds in the context of the response mounted by their respective governments to the global crisis. The purpose of this exercise is not to judge or criticize but rather to enhance awareness and stimulate debate regarding the real world challenges of public fund management in the face of intense economic pressures and competing political agendas.

Irish National Pensions Reserve Fund – The Irish government drafted a Bill to amend the rules governing the National Pensions Reserve Fund (NPRF), thus allowing the government to use money from the NPRF for a program to recapitalize some of the country’s failing domestic banks (Irish Times, 2009a). One part would come from the fund’s current resources and the rest would be provided by “frontloading” the Exchequer’s contributions to the fund for 2009 and 2010 (Irish Times, 2009b). In its 2009 annual report on Ireland, The International Monetary Fund (IMF) indicated that from 2008 to 2010, the Irish economy would shrink by a margin that would be considered the largest among advanced economies, and that using the NPRF for recapitalization “has diluted its primary role as a cushion for long-term obligations related to the aging population, to which it would need to return” (Finfacts, 2009).

Norway’s Government Pension Fund–Global/Sovereign Wealth Fund – The Norwegian government unveiled a fiscal stimulus package and started to use its Sovereign Wealth Fund as permitted within limits set by the fund’s guidelines. The terms of the fund “allow fiscal policy to be used actively to counter fluctuations in economic activity” as long as a designated long-term average rate is not exceeded (Financial Times, 2009). According to updates, the wealth fund underperformed its benchmark in Q1 of 2009, which was attributed to a weak market, and then went on to outperform its benchmark in Q2 by taking advantage of a sharp financial market rally (Sovereign Fund Institute, 2009).

Canada Pension Plan Fund – The Canadian government developed an Economic Action Plan that was outlined in the 2009 budget document. No changes to the Canada Pension Plan (CPP) or the fund’s mandate were made (Government of Canada, 2009a). In the same year, the government published an information paper on proposed changes to the CPP as part of the regular reviews of the plan that are required (Government of Canada, 2009b). In August 2009, the Canada Pension Plan Investment Board (CPPIB) reported that it made back 32 per cent of the previous year’s losses in the first quarter, thanks largely to the rebound in the stock markets. The chief executive of CPPIB saw this upswing as a re-affirmation of the Board’s belief in the need to “stick to those long-term horizons and ride out the short-term noises...” (Financial Post, 2009).

Ultimately, perhaps it is less a matter of individual decisions being considered good or bad, but more a question of how macro priorities are set, and whether decisions are measured against a coherent long-term strategy. It may well be a question of convictions vis-à-vis the governance system that has been set up. More likely than not, the stories of the three funds do not end there. In times of rapid economic/political changes, new opportunities will arise soon enough for a new round of decision-making.

4. Lessons learned - Challenges and strategies

Based on the selection of expert analyses, best practice research findings and international experience, a number of observations may be made in regard to major challenges and possible strategies for sound governance, which may be applied to pension fund management or other social security issues as deemed appropriate.

Risk management – Decisions regarding how much risk to take on and the management of that risk are critical to long-term value creation in a pension fund. Taking on the right type and amount of risk is predicated on a formal system of setting strategy, monitoring progress and rigorous quality control, which requires sound governance. Pension funds should make use of both quantitative and qualitative oriented disciplines for analyzing market dynamics, and then respond appropriately.

Appropriate time horizon focus – The differences between short-term and long-term investing are significant and it is important to understand when to apply which strategy. Pension funds are supposed to be long-term investments, but stakeholders with different agendas may adopt shorter term horizons, resulting in behaviours that may not be aligned with the long-term goals of the fund. A major governance challenge is therefore to manage the long-term plan but remain resilient in relation to short-term pressures that build up from time to time.

Ability to innovate – The concept of “early mover advantage” is well-known. It relates to successfully identifying and accessing capital markets and asset classes early in the cycle, ahead of the crowd. Funds choosing to invest in non-traditional, less studied asset classes, unconventional strategies or “newer” managers may face many pressures, not the least of which is peer pressure from both within and outside the organization. This generates a huge amount of stress that a governance structure would not be able to withstand without strong convictions and clearly defined objectives.

Alignment with a clear mission – In the real world of organizational, stakeholder and environmental imperatives, institutional funds often encounter difficulties reconciling competing interests under the umbrella of a shared mission. Even though theoretically the role of a pension fund is to produce value propositions for both members and sponsor, in practice it is not easy to satisfy the needs of both parties as envisioned. A clear statement of investment policy and objectives that is properly documented is an indispensable step to building alignment between the parties, and to ensure that the appropriate investment risk profile and strategy can be identified. In fact, best practice funds tend to have not only a clear primary objective, but also a number of defined secondary objectives that enable all parties to match operational goals with the intended mission.

Managing agents – In general, pension funds are not resourced to manage all of their activities in-house, so they employ external agents in both advisory and delegated roles. Many social security programs are moving towards a more market-based management approach. This usually involves outsourcing certain management functions such as strategic asset allocation and hiring external agents such as investment managers to manage the assets.

Consequently, these funds are exposed to the additional risk that the goals of the external agents or managers do not align with those of the fund. Governance is essential for monitoring work progress and controlling misalignments as soon as they arise. This is particularly important where a large line-up of managers is involved.

Arm's length independence from government – Building a stronger firewall by going beyond the minimum requirements for setting up a governance structure enhances the system's ability to resist pressures that may lead to imprudent fiscal/fiduciary decisions, especially when the economy is doing poorly and/or the markets are volatile. Helpful strategies to strengthen the firewall can range from publishing investment policy statements, annual reports and statements of intent to prohibiting certain practices such as delegation of the board's responsibility to appoint managers or the use of complex financial products without adequate analysis and proper approval.

Augmenting governance capabilities in times of crisis – Overall, the pension industry made a fairly weak response to the recent global crisis. Many pension funds felt constrained by the limits of their expertise and struggled in their efforts to assess the implications of the flux and flow of stressed financial markets. A number of strategic steps may be taken to help funds position themselves better when confronted by these unforeseen challenges. These include: intensification – stepping up board attention and mobilizing additional resources; prioritization – allocating time and energy more efficiently based on the assessment of the significance of issues; stronger risk management – combining the discipline of quantitative analysis with qualitative overlay within a broader framework as well as providing the risk management component with some measure of independence from investment management processes; and expansion of the belief structure – nurturing more elaborate investment beliefs with stronger convictions to cope with complex market conditions, promoting a greater diversification of assets and building up the multi-pillar framework.

5. Conclusion

Guidelines, best practices and models are valuable sources of reference but there is no single blueprint for reform. To be effective, governance provisions must be adapted to the unique circumstances of each scheme in every country at any particular time. Furthermore, governance resources and capabilities vary depending on multiple factors such as macroeconomic development and the general state of the financial sector. Sophisticated governance structures in OECD countries took years to evolve, so less developed countries facing multiple constraints and restrictions should not be held to unrealistic expectations.

To foster good governance and support the reform of social security programs, good intentions and technical know-how may not be sufficient; an enabling environment is also necessary to maximize the contribution that governance can make to the reform process. As Sin and Mao pointed out in “Hidden Pot of Gold: Responding to China's Pension Burden” (2007), successful implementation of pension investment practices is dependent on the readiness of a country's financial sector and its willingness to promote diversification across capital markets.

Finally, a culture of vigilance is critical for monitoring the dynamics of the reform process. This is especially important for balancing the long-term vs. short-term tensions that invariably arise. A strong and independent governance mechanism can help the fund stay on track from a long-term strategic perspective when short-term adjustments appear desirable. In an increasingly volatile investment environment, the stakes may rise even higher, not just in the Asia-Pacific region, but globally as well.

Bibliography

- Ambachtsheer, K.P. (2006, May). "High-Performance Cultures: Impossible Dream for Pensions?", *The Ambachtsheer Letter*.
- . (2007). *Pension Revolution: A Solution to the Pensions Crisis*. Hoboken: John Wiley & Sons, Ltd.
- Carmichael, J.; Palacios, R. (2004). "A Framework for Public Pension Fund Management", in A.R. Musalem; R.J. Palacios, *Public Pension Fund Management: Governance, Accountability, and Investment Policies*. Washington, D.C.: The World Bank.
- Clark, G.L.; Urwin, R. (2007). *Best Practice Investment Management: Lessons for Asset Owners from the Oxford-Watson Wyatt Project on Governance*. Watson Wyatt Worldwide.
- Daykin, C.D. (2004). *Financial governance and risk management of social security*. ISSA.
- Financial Post. (2009, August 13). Retrieved from <http://www.canada.com/business/fp/Pension+plan+recovers+fiscal+losses/1887802/story.html>
- Financial Times. (2009, January 26). Retrieved from <http://www.ft.com/cms/s/0/5cd3812a-ebbd-11dd-8838-0000779fd2ac.html>
- Finfacts. (2009, June 25). Retrieved from http://www.finfacts.ie/irishfinancenews/article_1017005.shtml
- Government of Canada. (2009a, January 27). Retrieved from <http://www.budget.gc.ca/2009/plan/bpc3a-eng.asp>
- Government of Canada. (2009b, May 25). Retrieved from http://www.fin.gc.ca/n08/data/09-051_1-eng.asp
- Halpern, S.W.; Irving, A. (2004). "Identifying and Adopting Best Practices for Institutional Investors", in J.C. Singleton, *Core-Satellite Portfolio Management: A Modern Approach for Professionally Managed Funds*. New York: McGraw-Hill.
- Iglesias, A.; Palacios, R.J. (2000, January). "Managing Public Pension Reserves Part I: Evidence from the International Experience", *The World Bank Social Protection Discussion Paper Series*. Washington, D.C.: The World Bank.
- Irish Times. (2009a, February 28). Retrieved from <http://www.irishtimes.com/newspaper/finance/2009/0228/1224241990718.html>
- . (2009b, February 12). Retrieved from <http://www.irishtimes.com/newspaper/ireland/2009/0212/1233867933446.html>
- ISSA. (2004). Guidelines for the investment of social security funds. International Social Security Association. Retrieved from <http://www.issa.int/aiss/content/download/48118/896138/file/TR-13-2.pdf>
- Maher, A. (2004). "Transparency and Accountability of Public Pension Funds", in A.R. Musalem; R.J. Palacios, *Public Pension Fund Management: Governance, Accountability, and Investment Policies*. Washington, D.C.: The World Bank.
- Sin, Y. (2008). *Understanding China's Pension System - Yesterday, Today and Tomorrow*. Hong Kong: Watson Wyatt Worldwide.
- Sin, Y.; Mao, L. (2007). *Hidden pot of gold: Responding to China's Pension Burden*. Hong Kong: CLSA.
- Sin, Y.; Zhang, W. (2009a, September). "Financial crisis, risk management and pension development", *China Finance*.
- Sin, Y.; Zhang, W. (2009b, September). "The global financial crisis: a perfect opportunity to reflect on pension fund development", *Insurers*.
- Sovereign Fund Institute. (2009, September 24). Retrieved from <http://www.swfinstitute.org/fund/norway.php>

Watson Wyatt Worldwide. (2007, November). Best practice investment governance going from good to great, Watson Wyatt Worldwide.

Yermo, J. (2008). "Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries", *Financial Market Trends*.

Limitations of reliance

Watson Wyatt has prepared this document for the International Social Security Association in preparation for the Regional Social Security Forum for Asia and the Pacific to be held in Manila, Philippines on October 21-23, 2009. No action should be taken based on this document as it does not give any detailed analysis pertaining to the specifics of each case.

In preparing this document we have relied upon data/information supplied to us by third parties. Reasonable care has been taken to gauge the reliability of the data/information, but this document carries no guarantee of accuracy or completeness and Watson Wyatt cannot be held accountable for any misrepresentation of data/information by the third parties involved.

This document is provided for the sole use of the surveyed participants for information and as a courtesy, without breaching hitherto agreed upon conditions governing the use of the document. This document is based on data/information made available to Watson Wyatt up to the date shown for the receipt and analysis of responses and takes no account of subsequent developments beyond that time.

No part(s) of the contents of this document may be modified or provided by the recipients to any other party without Watson Wyatt's prior written permission. No part(s) of the contents of this document may be disclosed by the recipients to any other party without Watson Wyatt's prior written permission except as may be required by law.

In the absence of any written agreement to the contrary, Watson Wyatt accepts no responsibility for any consequences arising from the recipients or any third party relying on this document including the opinions expressed therein. This document is not intended by Watson Wyatt to form a basis for or contribute in any way to any decision by the recipients or any third party to act or not to act on anything.