Technical Commission on Provident Funds and Allied Schemes

Technical Commission on Statistical, Actuarial and Financial Studies

Guidelines for the investment of social security funds

Table of contents

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Introduction

Social security funds are held by social security schemes in order to safeguard the schemes' ability to pay benefits and provide services, to generate investment income that helps to finance benefits and services, and, in many instances, to ease transitory demographic pressures.

In recent years, the number of member organizations of the International Social Security Association (ISSA) with such funds has grown significantly. As their experience has shown, the investment of these funds can make a critical contribution to the financial sustainability of their social security systems. However, experience has also shown that the investment of social security funds is not without risk. Imprudently or improperly invested, such funds can yield negative real rates of return, or can disappear altogether.

These factors led the ISSA to create a Study Group on the Investment of Social Security Funds. The Study Group consisted of officials of ISSA member organizations directly involved in the investment of social security funds as well as outside experts from institutions engaged in similar investments and from international organizations.

At its first meeting, held in Paris in December 2002, the Study Group identified, as a priority, the development of guidelines which could assist social security institutions in the investment of their funds. At its second meeting, held in Porto in April 2004, the Study Group examined draft Guidelines drawn from several sources and adapted to the special circumstances of social security institutions. The present Guidelines are the result of the Study Group's reflection and of comments subsequently received from several of its members.

These Guidelines are intended to provide social security institutions – whether they be government ministries, statutory bodies or private bodies – with general principles and considerations for the investment of social security funds. The principles and considerations are supplemented with commentaries that provide background information, describe acceptable alternative approaches, or discuss other factors that should also be taken into account.

The Guidelines have been formulated to take into account two distinct situations. In the first instance the entity administering the social security scheme is also responsible for investing the social security funds. In the second instance the entity responsible for investing the social security funds is distinct from the social security scheme.

There are many different models of social security around the world, comprising schemes in developing and industrialized countries. Financial markets, legal frameworks and regulatory and supervisory structures vary from country to country. In drafting the Guidelines, considerable attention has been given to providing the degree of flexibility required to respond to these differences. However, a practical consequence is that the Guidelines cannot reflect every possible circumstance. Therefore, in applying the Guidelines, they must be adapted, as appropriate, to the specific situation of each scheme and each country.

I. Governance prerequisites: *Governance structure*

A sound governance structure is essential for the effective investment of social security funds. The governance structure should ensure an appropriate division of operational and oversight responsibilities, and the suitability and accountability of those with such responsibilities.

Governance[1] *is a complex subject, with many dimensions. It would not be possible, in Guidelines such as these, to address all aspects of good governance. This and the next section of the Guidelines describe the minimum governance principles and considerations that must be taken into account when a social security institution undertakes the investment of the funds entrusted to it.*

1. Identification of responsibilities

There should be a clear identification and assignment of operational and oversight responsibilities in the governance of a social security scheme. This should be the case whether a scheme is administered by a government ministry or by an entity (e.g., a statutory body, such as an autonomous institution) established for this purpose. In the latter case, the legislation establishing the entity should set out the legal status of the entity, its main objectives and its internal governance structure.

2. Governing body

(a) If an entity other than a government ministry is established to administer a social security scheme, the ***governing body*** of that entity should be vested with the power to take the actions necessary for the scheme to fulfil its legislative mandate. The governing body should be subject to the least possible political interference or influence. The governing body is ultimately responsible for ensuring that the provisions of the legislation establishing the social security scheme are observed and that the interests of ***scheme members***, beneficiaries and other ***stakeholders*** are protected. The governing body should not be able to absolve itself completely of its responsibilities by delegating certain functions to external service providers but should retain responsibility for monitoring and oversight of those service providers.

> **Commentary:** *Independence from political interference or influence does not mean that the governing body should operate without reference to the legislative framework established by the national parliament or the policies of the government. Nor does it preclude appropriate consultations with parliamentary and government officials or other government agencies. However, it does mean that there should not be political interference in the decisions taken by the governing body within the legislative mandate given to it.*
>
> *In establishing a governing body for a social security scheme, many countries require tripartite representation of workers, employers and government. The International Labour*

[1] Terms which appear in ***bold italics*** in the text of the Guidelines are defined in the glossary of terms found in the appendix.

Organization, among others, has long advocated tripartite representation as a means of protecting against unwarranted political interference and ensuring input from those most affected by a social security scheme.

(b) The responsibilities of the governing body should be consistent with the overriding objective of the social security scheme, which is to pay the benefits and provide the services promised. The governing body should strive to maintain the financial sustainability of the social security scheme by monitoring and managing all the risks associated with the scheme, including in particular the demographic, financial and broader economic risks. Under the ***financial system*** adopted, the contribution level established and investment income should be sufficient to finance the benefits and services, and risk management should be applied in the assessment of the long-term sustainability of the scheme.

3. Investing institution and investment committee

(a) In accordance with the legislation establishing a social security scheme and/or the decision of a scheme's governing body, the ***investing institution*** may be either the entity administering the social security scheme or an entity established expressly for the purpose of investing the scheme's funds. In the latter case, there should be a clear statement of the legal status of the investing institution, its main objectives, and its internal governance structure (including its governing body). Moreover, in such a case, Guidelines 2, 4, 5, and 6 should apply to the governing body of the investing institution, and guidelines 7, 9, 10, 11, 12 and 13 to the investing institution itself.

Commentary: *In some instances, there may be advantages to establishing an investing institution which is distinct from the entity administering the social security scheme. For example, when a government ministry is responsible for administering a social security scheme, the creation of an investing institution which is independent of that ministry may ensure protection against both political interference and the perception of political interference in the investment decisions which are taken.*

(b) The governing body (bodies) of the social security scheme and/or of the investing institution should appoint an investment committee responsible for developing the ***investment policy*** and the ***investment strategy***, recommending them to the governing body (bodies), overseeing their implementation, and evaluating their effectiveness. The investment committee should meet regularly and report its activities to the governing body (bodies). The frequency of its meetings should take into account the responsibilities and tasks assigned to it.

Commentary: *It must be stressed that the investment committee is not the same as the investing institution or the governing body of the social security scheme. The investment committee reports to the governing body of the social security scheme or the governing body of the investing institution and is charged with recommending, overseeing and evaluating the application of the investment policy and investment strategy.*

In some instances, the chairperson of the governing body of the investing institution chairs the investment committee. The chief executive officer of the entity administering the social security scheme may be a member of the investment committee. The other members of the committee should be chosen from among the members of the governing body (bodies) of the social security scheme and/or of the investing institution on the basis of their expertise and experience in the various key aspects of investment management. Outside experts should be asked to serve on the investment committee if the required expertise is not available among the members of the governing body (bodies).

4. Accountability

(a) The governing bodies of the social security scheme and of the investing institution should be accountable to the scheme members, beneficiaries, and other stakeholders of the social security scheme. In order to ensure the accountability of the governing bodies, their members should be liable for their actions and for their failure to act.

> ***Commentary:*** *One means for determining whether a member of a governing body has properly carried out his/her responsibilities is to apply the principle of "duty of care". Under this principle, a member, in exercising the powers of office or discharging the duties, is required to act honestly and in good faith, with a view to the best interests of the social security scheme and scheme members. As well, he or she is required to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (i.e.* ***prudent-person*** *principles). If the member, by reason of his/her profession or business, has a particular knowledge or skill relevant to his/her duties of office, he/she is expected to employ that particular knowledge or skill in exercising those duties.*

(b) Accountability of the governing bodies of the social security scheme and of the investing institution requires that there should be transparent processes for selecting members and for taking decisions as well as regular meetings and disclosure of decisions and information to scheme members, beneficiaries and other stakeholders, including information regarding the financing of the scheme and its financial status.

> ***Commentary:*** *At the time of appointment to a governing body, a member should disclose all business interests and affiliations that may result, or appear to result, in a conflict of interest with the execution of his/her duties on the governing body. The member should be expected to disclose any business interest or affiliation that develops after his/her appointment and while he/she is on the governing body.*
>
> *If the governing body is dealing with an issue in which the member has a business interest or could appear to have such an interest, the member should withdraw from the part of the meeting in which the issue is being discussed and not vote on the issue. It should be noted in the record of the meeting that the member removed himself/herself from consideration of this issue.*

5. Suitability

Membership of the governing bodies of the social security scheme and of the investing institution (as well as any specific investment committee) should be subject to minimum suitability standards, in order to ensure a high level of integrity and professionalism in the governance and administration of the social security scheme and of the investing institution.

6. Expert advice

Where they lack sufficient expertise to make fully informed decisions and fulfil their responsibilities, the governing bodies of the social security scheme and of the investing institution should seek expert advice or appoint professionals to carry out certain functions. Contracts for the provision of expert advice should normally be open to competition, separately for each type of expert advice required. Experts should be appointed having regard to the quality of their expertise and not solely on the basis of the lowest tender.

> ***Commentary:*** *In engaging external advisors, the governing body (bodies) of the social security scheme and/or of the investing institution must ensure that they have sufficient*

knowledge to define their investment requirements, to understand the implications of the proposals presented to them, and to evaluate those proposals within the framework of the social security scheme's overall objectives. If the governing body or bodies are uncertain whether they have the necessary knowledge, they should obtain independent advice from experts with no material interest in the outcome of the decisions taken.

7. Auditor

(a) An auditor, independent of the government, the governing body of the social security scheme, the entity administering the social security scheme and the investing institution, should be appointed by the government or the governing body of the social security scheme to carry out annual audits of the social security scheme. The auditor should be free from political interference.

> ***Commentary:*** *If the investing institution is distinct from the entity administering the social security scheme, there should be independent audits of each.*

(b) If as a result of carrying out his/her professional and/or statutory duties, the auditor becomes aware of information which could have a significant negative effect on the financial situation or the administrative and accounting organization of the scheme, or of significant weaknesses in the systems of control, the auditor should make a report to the government or governing body (whichever appointed him/her). If the auditor reports to the governing body and the governing body does not take appropriate remedial action in a specified time, the auditor should also make a report to the government.

(c) An opinion from the auditor should be included in the annual financial statements of the social security scheme, which should be publicly available.

8. Actuary

(a) An actuary should be appointed by the government or the governing body of the social security scheme to carry out periodic actuarial reviews of the scheme. The actuary should be free from political interference.

> ***Commentary:*** *If the actuary is an employee of the government ministry overseeing the social security scheme, or of the governing body or the entity administering the scheme, the work of the actuary should be subject to independent peer review or actuarial audit.*

(b) If as a result of carrying out his/her professional and/or statutory duties, the actuary determines that the financial sustainability of the social security scheme is materially at risk to the extent that the scheme may not be fulfilling or is unlikely to be able to fulfil its obligations, or that it will not be able to comply with the statutory provisions of the scheme, or that it faces the possibility of material financial shortfalls of income relative to its expenditure in the future which will not be covered by reserves, the actuary should make a report to the government or the governing body of the social security scheme (whichever appointed him/her). If the actuary reports to the governing body of the social security scheme and the governing body does not take appropriate remedial action in a specified time, the actuary should also make a report to the government or directly to the parliament.

> ***Commentary:*** *The process for determining the assumptions underlying the actuarial review should be transparent and based on objective considerations.*

(c) The report of the actuary on the actuarial review should promptly be made publicly available.

9. Custodian

Custody of the assets of the social security scheme can be carried out by the entity administering the scheme, by the investing institution, by a government entity such as the central bank or treasury, or by an independent ***custodian***. If an independent custodian is appointed by the governing body of the social security scheme to hold and ensure the safekeeping of the assets of the scheme, the assets of the scheme should be legally separated from other assets of the custodian. The custodian should not be able to absolve itself of responsibility by entrusting to a third party all or some of the assets in its safekeeping.

> ***Commentary:*** *The custodian should perform independent transaction and position reconciliations at specified intervals.*

II. Governance prerequisites: *Governance mechanisms*

In addition to an effective governance structure, there should also be suitable governance mechanisms. Social security schemes should have appropriate control, communication and incentive mechanisms that encourage good decision-making, proper and timely execution, transparency and regular review and assessment.

10. Systems of control

There should be appropriate systems of control in place to ensure that all persons or bodies with operational and oversight responsibilities act in accordance with the objectives set out in the legislation establishing the entity administering the social security scheme or the investing institution, when the investing institution is distinct from the entity administering the social security scheme. Such systems of control should cover all basic organizational and administrative procedures, including performance assessment, compensation mechanisms, information systems and processes, risk management procedures and regular review of expert advisers and of any contractual arrangements.

11. Internal reporting

Reporting channels between the entity administering the social security scheme, the governing body of the scheme, the investing institution, the government and other persons involved in administering the scheme should be established in order to ensure the effective and timely transmission of relevant and accurate information.

12. Public disclosure

The governing bodies of the social security scheme and of the investing institution should disclose relevant information to all parties involved, including scheme members, beneficiaries and other stakeholders, in a clear, accurate and timely fashion.

> ***Commentary:*** *The information to be disclosed on an annual basis should include at least the following:*

- *the duties, objectives and mandate of the entity administering the social security scheme, its governing body, and the investing institution (if different from either of the previous two);*
- *the committees of the governing body of the social security scheme, as well as their composition, mandates and activities;*
- *a financial statement of the scheme for the previous year, including information on income, expenditures, assets and liabilities;*
- *the opinion of the auditor on the financial statement;*
- *the report of the actuary on the actuarial review (if such a report has been made since the previous disclosure of information).*

Disclosure should not extend to information that would compromise fiduciary responsibilities or prejudice investment transactions.

13. Redress

Scheme members, beneficiaries and other stakeholders should be granted access to prompt statutory redress mechanisms through a body established for this purpose or through the courts.

III. Investments

14. Objectives

(a) There are two *primary* objectives for the investment of social security funds:

(i) *security* – the investments should assist the social security scheme to meet its commitments in a cost-effective way;

(ii) *profitability* – the investments should achieve maximum returns, subject to acceptable risk.

Investments of social security funds should be made with a view to achieving a reasonable balance between the twin objectives.

Commentary: *The importance of the security of the assets and the return on assets to maintain the financial sustainability of the social security scheme according to its financial system should always be considerations in making decisions on investments. The liabilities of the social security scheme should take into account the scheme's maturity and liquidity requirements.*

(b) The social and economic utility of investments may also be taken into account. In such a case, however, it should be subsidiary to the primary objectives of security and profitability. As well, there should be clear criteria for determining the circumstances and to what extent social and economic utility will be taken into account. Where investment in a particular venture of economic and social utility is considered desirable by the government and/or by the governing body of the social security scheme but the returns likely to be achieved are below market norms, the investment should be structured so that the subsidy is made from other government resources, in order to avoid compromising the fiduciary responsibilities of the social security scheme.

Commentary: *Investments with social and economic utility include, for example, private-sector initiatives, state enterprises, student loans, low-cost housing, old-age facilities, health* *infrastructure, tourism, and projects enhancing human resources. In many countries, these types of investments may make a substantial contribution to long-term national growth rates even if the indirect rates of return may not always be fully reflected in the monetary rates of return. By contributing to long-term national economic growth, they can improve the financial status of the social security scheme in terms of the number of members, the amount of their insurable earnings, and the rate of return on the scheme's investments.*

Investments that are made on the basis of social and economic utility should be continuously monitored. To enable the social security scheme to do this, it should have a seat on the board of directors of such projects whenever there is a substantial investment of social security funds.

15. Integrated approach

The investment of the funds of a social security scheme should take into account the financial system under which the scheme operates, and be consistent with its short-, medium- and long-term financing objectives. The commitments of the scheme established by legislation, expected future cash-flows and the appropriateness of different types of investments for meeting the scheme's investment objectives should be taken into account.

16. Investment policy and strategy

(a) The investment policy of a social security scheme should be based on prudent-person principles and appropriate ***quantitative restrictions***. It should take into account the following concepts:

- risk management;
- ***diversification*** and ***dispersion***;
- matching assets and liabilities, including considerations of duration and maturity;
- currency matching; and
- performance measurement and monitoring.

Commentary: *In establishing the investment policy and strategy, the governing bodies of the social security scheme and of the investing institution should determine the degree of risk and risk tolerance the scheme is able to sustain. Factors such as the volatility of contributions and assets should be considered along with the financial objectives. The governing bodies of the social security scheme and of the investing institution should have a sound understanding of the scheme's obligations, the purpose of the investments, and the appropriate mix of assets required to ensure the scheme's financial sustainability.*

(b) The investment policy and investment strategy should be consistent with the financing objective of the social security scheme and its cash-flow requirements. The policy should require that the investing institution have in place appropriate systems of control to ensure that the five concepts noted in (a) have been properly taken into account.

(c) The national economic, social and financial importance of the investment of social security funds requires that, within the context of these Guidelines, the investment policy of a social security scheme should be established taking into consideration the economic policies of national financial authorities such as the ministry of finance and/or central bank.

Commentary: *In many countries, social security funds comprise a major part of the capital market. Therefore, the investment of those funds should take into consideration long-term national objectives that may not be entirely reflected when pursuing a strategy based* *exclusively on maximizing returns. Ultimately, the sustainability of any social security scheme depends on national economic growth.*

While the views of national financial authorities are a legitimate consideration in setting the investment policy and strategy, they should not be involved in the implementation of the strategy. In particular, those authorities should not be allowed to dictate the specific investments to be made by a social security scheme or its investing institution.

(d) A statement of the investment policy and strategy should be formally articulated by the governing bodies of the social security scheme and of the investing institution and should be publicly available.

Commentary: *The investment policy should be reviewed by the governing body of the investing institution regularly (at least once every three years). The investment strategy should be subject to ongoing review and evaluation.*

17. Restrictions on investments

(a) No minimum level of investment should be prescribed for any given category of investment, except on an exceptional and temporary basis and for compelling prudential reasons.

Commentary: *The prescription against minimum levels of investments for given categories refers to rules that are externally imposed on a social security scheme or investing institution. It especially applies in regard to government debt. Social security funds should not become a means for governments to finance deficits and debt.*

The prescription does not, however, preclude the governing body of a social security scheme or investing institution from setting minimum levels of investments as part of its investment policy.

Provision should, in particular, be made for a minimum level of cash and/or short-term money-market securities required to pay immediate benefits and meet other ongoing obligations as they become due.

(b) Maximum levels of investment by category should be set with reference to ***prudential rules***. The investing institution should be allowed to exceed such ceilings under certain conditions (e.g. time limits), and possibly subject to prior authorization by the governing body of the social security scheme and/or the government.

(c) Investments in a given individual asset or security, or in the assets or securities of a particular industry or entity other than the government itself, should be limited as a proportion of a social security scheme's total portfolio. The investing institution should not hold more than a specific proportion of the total ***market value*** of a given type of asset or of the assets of a particular industry or entity.

(d) A list of admitted/recommended assets can be drawn up by the government or by the governing body of the social security scheme. Such a list could either be exhaustive and compulsory or optional. In the latter case, the investing institution would have to justify any substantial deviation from the list.

Commentary: *Caution should be exercised before adopting a "list" approach which places tight constraints on strategic asset allocation. If a list approach is used, one of admitted assets is less problematic than a list of recommended assets.*

(e) Investment in certain categories of investments should be limited or prohibited – for instance, loans without appropriate guarantees or on terms which would not be acceptable to the market, unquoted shares, and investments which raise major risks of conflicts of interest. Individually placed and unquoted investments should be subject to particularly stringent disclosure and approval mechanisms, with a requirement to demonstrate that the terms of the investment are fair and not subject to improper influence or control. Measures should be in place to prevent unlawful appropriation of funds.

(f) International investments should normally be restricted to investment-grade securities appropriate for a social security scheme. Care should be taken to manage any currency risks.

(g) The use of financial ***derivatives*** as an investment management instrument may be useful and effective if it is carried out in a prudent fashion to manage and ***hedge*** risks (e.g., to reduce exposure to currency fluctuations). However, unhedged positions in derivatives can expose the investing institution to significant risk. Appropriate risk management structures should be set in place to govern the use of derivatives, and compliance with these structures should be carefully monitored.

18. Prudent-person principles

(a) Application of prudent-person principles or the ***prudent-expert*** concept can make it possible to reduce quantitative restrictions on investments. This, however, requires the governing body of the social security scheme and the government to have confidence in the investing institution's internal systems for management and control of its investment portfolio. If prudent-person principles are applied to managing the investment of social security funds, they should be set out, with a minimum body of rules, by the governing body of the social security scheme or by the government.

> ***Commentary:*** *Unless the modalities of application of prudent-person principles are sufficiently precise, imprudent attitudes may develop. These principles – or at least their interpretation – may vary substantially from one country to another.*

(b) Whatever principles the investing institution may adopt, there have to be competent and honest managers to apply them. It is, therefore, essential to ensure the competence and integrity of managers. The governing body of the social security scheme or of the investing institution should adopt criteria concerning the expertise that is required of investment managers and other advisers on investment policy and strategy and their implementation.

(c) Insofar as prudent-person principles are applied and quantitative restrictions eased, greater fiduciary responsibility should be placed on officials of the investing institution and members of its governing body in order to ensure the accountability of any who abuse the independence conferred by the application of these principles. The social security scheme should have an appropriate structure to control decisions taken on the basis of the prudent-person principles (for example, through the nomination of other qualified persons on the investment committee and the governing body of the investing institution or through a system of external and independent review).

19. Valuation

Assets should be valued in accordance with generally accepted accounting principles. The objective should be to ensure that information about investments is as transparent as possible. To achieve this goal, there should also be disclosure of the results that would have been obtained using the main alternative methodologies (for example, market value or ***fair value*** when assets are shown at ***historical cost***).

20. Performance analysis

(a) Periodic analysis of each asset class and the portfolio as a whole should be carried out to determine nominal, risk-adjusted, and inflation-adjusted (real) rates of return. The analysis should include comparisons with target rates of return, and with appropriate benchmarks, to allow the governing body of the social security scheme to assess investment performance, to update the asset allocation strategy, and to make adjustments (as may be required) to the investment policy and strategy.

(b) The analysis of investments should be publicly disclosed.

Appendix

Glossary of terms

Custodian	The agent engaged by the governing body of the social security scheme or of the investing institution to hold and safeguard the assets of the social security scheme.
Derivatives	Synthetic financial market products based on other instruments such as shares, bonds, indices, or commodities.
Dispersion	The distribution of assets among different categories of assets.
Diversification	The distribution of specific assets within a given category of assets.
Fair value	Asset values based on the price that would be agreed upon in an arm's length transaction between knowledgeable, willing parties under no compulsion to act. This technique is often used for assets which are not traded/sold often enough to establish a market value.
Financial system	The method whereby funds are allocated in order to provide the expected benefits and services as they fall due, and the equilibrium between receipts and expenditures is maintained. Financial systems range from full-funding to pay-as-you-go.
Governance	The systems and processes by which an institution or government manages its affairs with the objective of maximizing the welfare of and resolving the conflicts of interest among its stakeholders.
Governing body	The group of persons who, under the legislation or by-laws establishing an entity, is given the responsibility for the governance of the entity.
Hedge	A form of risk compensation using a counter-trade or covering transaction designed to offset an existing or potential risk position by eliminating or diminishing the element of risk (in particular, price, interest rate or exchange rate risk).
Historical cost	Asset values based on the price paid in the past for the same or comparable assets.
Investing institution	The entity responsible for the investment of a social security scheme's funds. In accordance with legislation and/or the decision of the scheme's governing body, this can be either the entity administering the social security scheme or an entity established expressly for this purpose.
Investment policy	The investment principles and procedures established by the governing body of the investing institution.

Investment strategy	The plan approved by the governing body of the investing institution to implement the investment policy.
Market value	Asset values based on the price for the same or comparable assets on open markets at the time of valuation.
Prudent-person	Rules or principles which govern individual behaviour, and which require a person to exercise the same care, diligence and skill in discharging his/her duties of office as a reasonably prudent person would exercise in comparable circumstances.
Prudent-expert	Rules or principles which underline the need for genuine expertise as well as behaviour consistent with the prudent-person principles.
Prudential rules	Any rules (quantitative restrictions, prudent-person, prudent-expert, etc.) whose objectives are the promotion of the financial security of those concerned.
Quantitative restrictions	Rules which prescribe either minimum or maximum allocation of investments in specific assets or classes of assets. Depending on the country concerned, such rules may be found in the legislation establishing the social security scheme, in directives of national financial authorities such as the ministry of finance or central bank, or in decisions of the scheme's governing body.
Scheme members	The persons protected by a social security scheme by virtue of the contributions which they pay or which are paid on their behalf.
Stakeholders	All individuals and organizations materially affected by the social security scheme, including (as may be appropriate under the legislation establishing the scheme) scheme members, beneficiaries, employers, workers, organizations representing any of these, and the government.