PENSION FUND MANAGEMENT: GOVERNANCE AND REGULATORY ISSUES

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Introduction

- Pension reforms commonly lead to an increased role for funding
- Crucial element is appropriate investment of assets – main focus of this presentation
- We examine the nature and influence of governance and regulatory aspects in archetypal established mandatory systems, to draw lessons
- Mandatory nature means appropriate protection for individuals of particular importance

Contents

- The basic arithmetic of funding
- Models of mandatory funded pensions
- Governance issues in investment
- Regulatory issues in investment
- Performance of mandatory funded schemes

The basic arithmetic of funding

- Aaron conditions: return to pay-as-you-go depends on population growth, productivity and dependency ratio, while return to funding depends on rate of return on assets invested and passivity ratio
- Funding’s advantage depends on whether rate of return exceeds wages growth (compounded if dependency ratio exceeds passivity)

- Economically, unlikely that wages growth could exceed asset returns for long periods (otherwise build-up of debt)
- Empirically, over last 30 years, there has been excess of at least 2%
- *But whether potential rates of return realised depends on efficiency of the investment process, including costs, and risks incurred. Appropriate governance and regulation help to ensure efficiency*

- Issues in pension fund investment
  - Optimal trade-off of risk and return sought, whose nature depends on liabilities
  - Replacement ratio depends on average earnings, so investment seeks to exceed it
  - Given long duration of pension liabilities, real assets (equities and property) are appropriate for part of the portfolio, unless a fund is winding up (short duration liabilities)
  - Defined benefit funds introduce insurance elements (shortfall risk) absent for defined contribution

Models of mandatory funded pensions

- Personal defined contribution funds managed on decentralised basis (Chile)
- Personal defined contribution funds invested centrally by public bodies (Singapore, Malaysia)
- Mandatory occupational defined contribution funds (Australia, Switzerland)

Table 1: Characteristics of mandatory funded pension systems

	Assets (% of GDP)	Coverage	Contribution rate	Benefit type	Asset management
Chile	39% (1995)	99% members; 58% contribute	13%	Defined contribution	Decentralised (personal)
Singapore	56% (1996)	90% members, 67% contribute	40%	Defined contribution	Centralised
Malaysia	47% (1996)	86% members, 50% contribute	23%	Defined contribution	Centralised
Switzerland	73% (1994)	90%	7%-18%	Defined contribution as minimum	Decentralised (occupational)
Australia	56% (1996)	92%	15% (in 2002)	Defined contribution as minimum	Decentralised (occupational)

Governance and regulation

- Governance – concerns issues of control over funds exerted by beneficiaries and/or ultimate liability holders, under normal legal system
- Regulation – concerns issues of control over funds exerted by supervisory agency nominated by government for specific oversight of the sector in question
- Governance and regulation are mutually reinforcing and not independent

Governance issues

- Governance structures
  - In personal pensions, governance operates largely via consumers’ ability to exit and desire of investment firms to maintain reputation. Weakness shown in UK, with high costs of transfer
  - In occupational funds, form of trust, foundation or captive insurance company. Personal liability of trustees for sound investment decisions, also consistent with regulations. Weakness shown in UK with Maxwell scandal – abuse of assets with trustees’ knowledge as well as fraud.

- – Key issues for occupational funds include
    - who nominates trustees and asset managers?
    - how knowledgeable are trustees?
    - should employees be a majority?
- – In public funds – parliamentary or government nominees, subject to government oversight
- – In all structures, important role for information, performance measurement and control of administrative costs. Issues of governance also arise from politicisation and from corporate governance *by* funds

- Information disclosure
  - Information for consumers essential complement but not substitute for regulation (lack of understanding and countervailing power)
  - Should ideally include investments, charges, returns, individual balances, actuarial projections
  - Chile – needed to facilitate transfer mechanism – full information 3 times a year, and daily valuations
  - Malaysia and Singapore – only value of individual accounts
  - Australia and Switzerland, annual statement, including investments and benefits

- Performance measurement
  - Calculation of both returns and risks on a portfolio during a given period by an independent body (e.g. consultant)
  - Essential in personal funds to enable individuals to exercise informed choice, exercise governance via exit
  - Public funds need it for parliamentary oversight
  - In occupational funds, of relevance mainly to bearer of ultimate risk (company in DB, individual in DC)
  - Used by regulators in personal DC systems

- Control of administrative costs
  - Reduce realised investment returns, may link to governance failure as well as market structure/economies of scale
  - Particularly high in Chile (costs of switching, promotional costs, costs of running individual accounts)
  - Low for provident funds, intermediate for occupational funds
  - Higher for occupational DB than DC funds
  - Issue of active versus passive management

- Politicisation of investment
  - Key governance issue for centralised funds, impacting on investment returns
  - In worst cases, finance government consumption or “white elephant” projects, avoiding international investment, vulnerable to inflation
  - Examples, Zambia and Nigeria with real returns of –20% to –50% in 1980s
  - Singapore – investment efficient, but returns pre-empted by government
  - US – owing to political interference and exemption from some regulations, public pension funds realise lower returns, with focus on local projects – also lower funding levels

- Corporate governance
  - Means for ensuring management of companies in which funds invest are not acting contrary to investors’ interests
  - To be effective, legal system needs to support investors’ rights and not managers’ interests
  - “Corporate governance movement” among US public sector schemes – effects on returns a matter of controversy
  - Mandatory funds may easily dominate domestic shareholder base – need to monitor managers since liquidity of stakes low
  - In most cases mandatory funds are passive investors or invest largely in government bonds or international assets

Regulatory issues

- Particularly essential for decentralised funds
- Review case for public intervention in market mechanism
  - Information asymmetry (personal pensions, annuities)
  - Externality (banking more than pension funds)
  - Monopoly (occupational/mandatory pensions)
  - Other issues – ensure tax privileges not misused, underpin retirement income security and efficiency of capital and labour markets

- Role of pension regulator includes
  - Manage institutional structure of the sector
  - Oversee information disclosure
  - Ensure records maintained on contributions and rights to benefits
  - Review collection of investment and cost data
  - Enforce laws on pension reserves, management and benefits
- Possible models
  - Chile for personal funds with single agency, on site inspections, continuous assessment of transactions
  - Netherlands for occupational funds and insurance, oversees both benefits and investments, involvement with structural issues

- Prudent person and portfolio restrictions - general considerations
  - Quantitative limits on “risky assets” versus requirement to diversify prudently
  - Logic of the quantitative approach
    - Focus on the investment not the portfolio
    - Prudence equals low risk assets
    - Instrument by instrument approach
    - Overrides free choice of investments

- Logic of the prudent person approach
    - focus on the behaviour of the investment manager
    - assumes diversification appropriate
    - allows free choice of investment subject to diversification
- Back-up for each of solvency rules in DB schemes
- Polar extremes rarely adopted

- Case against quantitative restrictions includes:
  - hinders appropriate investment strategies
  - harder to allow for duration
  - focus on assets and not portfolio
  - inflexibility
  - adverse incentive effects (for investors and governments)
  - limit scope for international investment
  - adverse effects on asset management sector and the economy more generally

- Case against prudent person rules includes:
  - inexperienced and poorly managed sectors
  - need for transparency, and high degree of trust
  - restrictions more readily monitored
  - capital outflow controls
  - narrow interpretations of risk and safety by courts

- National experience (regulations subject to amendment)
  - Chile – quantitative restrictions which are being gradually eased, now including venture capital, derivatives and foreign assets (20%), 45% maximum for government bonds
  - Singapore – government institutions free to diversify
  - Malaysia – 70% to be in government bonds
  - Australia – prudent person approach since 1983
  - Switzerland – shift to prudent person currently underway

- Returns and contributions regulation
  - Counterparts to solvency regulation in defined benefit schemes
  - Chile, minimum return relative to average and also maximum, with use of profitability reserves (aim of consumer protection)
  - Singapore – returns to consumers set relative to bank deposit rates, regardless of actual returns
  - Switzerland – minimum return of 4%, which becomes target and promotes conservative investment
  - Australia – obligation on employers to make mandatory contributions – no returns regulation

- Insurance and guarantees
  - Often desired for social reasons
  - Economic issue of moral hazard arises from such public guarantees, other than for fraud, necessitating monitoring, capital or portfolio restrictions
  - Arguably most serious for defined benefit funds (e.g in United States)
  - Switzerland – guarantee fund against insolvency of pension provider
  - Australia - only guarantee against fraud
  - Chile - government guarantees minimum return if pension fund returns inadequate

- Other regulation related to fund management and governance
  - Separation of custody of securities
  - Capital requirements for asset managers
  - Loss sharing for managers
  - Restrictions on commissions
  - Separation of fund from company in occupational funds
  - Accounting standards
  - Authorisation, merger and closure of funds
- Range of liability regulations (e.g. on rights to benefits)

Performance of mandatory funded schemes

- Acid test of effectiveness of governance and regulation
- Average returns highest in Chile and Malaysia – Singapore hindered by government pre-emption and Australia, Switzerland by historic portfolio regulations
- Returns compare poorly with UK and Netherlands – prudent person rules, and greater incentives and scope to maximise returns in occupational DB than DC funds
- Data do not allow for administrative costs – worsen Chilean performance

Table 4: Portfolio distributions of mandatory funded pension systems

	Bonds	o/w Public	o/w Private	Shares	Property	Loans and mortgages	Short term assets	Foreign assets
Chile (1994)	45	39	6	33	2	13	6	1
Singapore (1996)	70	70	0	0	0	0	28	0
Malaysia (1996)	55	34	21	16	1	0	30	0
Switzerland (1994)	28	-	-	14	16	41	2	0
Australia (1995)	15	13	2	41	9	0	20	14
Memo: Brazil (1997)	20	8	18	34	13	12	13	n/a
Memo: UK (1996)	14	n/a	n/a	78	5	0	4	27
Memo: Netherlands (1996)	63	n/a	n/a	26	8	n/a	3	23

Table 5: Estimated real total returns for mandatory funded pension systems

In percent per annum, standard deviations in brackets

1970-95	**Real return**	**Average earnings**	**Global portfolio**	**Domestic balanced portfolio**	**Return less average earnings**	**Return less global portfolio**	**Return less domestic balanced**
Chile	-	2.1 (6.3)	-	-	-	-	-
Singapore	1.3 (2.0)	6.9 (3.3)	5.1 (18.4)	-	-5.6	-3.8	-
Malaysia	3.0 (3.9)	4.4 (2.9)	6.7 (17.2)	-	-1.4	-3.7	-
Switzerland	1.7 (7.5)	1.5 (2.1)	3.7 (17.0)	2.4 (18.1)	+0.2	-2.0	-0.7
Australia	1.8 (11.4)	1.0 (3.4)	6.1 (18.2)	3.5 (17.5)	+0.8	-4.3	-1.7
Memo: Netherlands	*4.6 (6.0)*	*1.4 (2.6)*	*4.8 (14.7)*	*5.5 (18.3)*	*+3.2*	*-0.2*	*-0.9*
Memo: UK	*5.9 (12.8)*	*2.8 (2.3)*	*5.9 (15.0)*	*4.7 (15.4)*	*+3.1*	*0.0*	*+1.2*
1980-95							
Chile	13.0 (9.5)	3.2 (5.7)	9.1 (19.1)	-	+9.8	+4.1	-
Singapore	2.3 (2.0)	6.4 (3.5)	9.2 (15.3)	-	-4.1	-6.9	-
Malaysia	4.3 (2.6)	4.1 (3.0)	11.7 (14.0)	-	+0.2	-7.4	-
Switzerland	1.8 (7.7)	0.8 (1.3)	9.2 (15.8)	3.4 (18.6)	+1.0	-7.4	-1.6
Australia	6.1 (8.6)	-0.1 (2.2)	10.2 (17.8)	8.8 (15.8)	+6.2	-4.1	-2.7

Conclusion

- Useful to highlight the nature of the risks impinging on the realised returns to individual members of funded schemes. Regulation and governance can only address first two
  - Risks arising from the operation of the pension system (political interference, poor management, conflicts of interest, administrative costs, competition)
  - Risks arising from inappropriate regulation. (portfolio restrictions)
  - Risks arising from the performance of financial-asset markets (domestic and global) *(not avoidable)*
  - Risks arising from the nature of the pension system (longevity risk). *(needs appropriate design of reform)*

Some lessons from global experience

Prudent person regulation, where feasible, superior to portfolio restrictions

Public investment of pension monies suffers risks of politicisation

Crucial that regulation of private asset managers and pension fund trustees be sound

Occupational funds, where feasible, are superior to personal pensions owing to costs, albeit with incentive problems in investment of DC funds

In developing or transition economies, the case for personal pensions becomes stronger