

The background of the book cover is a photograph of an elderly woman from behind, wearing a bright green patterned sari and a black crop top. She is standing on a concrete step in front of a blue-painted wall and a wooden door. The wall has some peeling paint and a small red mark. The woman is looking down at something in her hand.

SAVING THE NEXT BILLION FROM OLD AGE POVERTY

global lessons for local action

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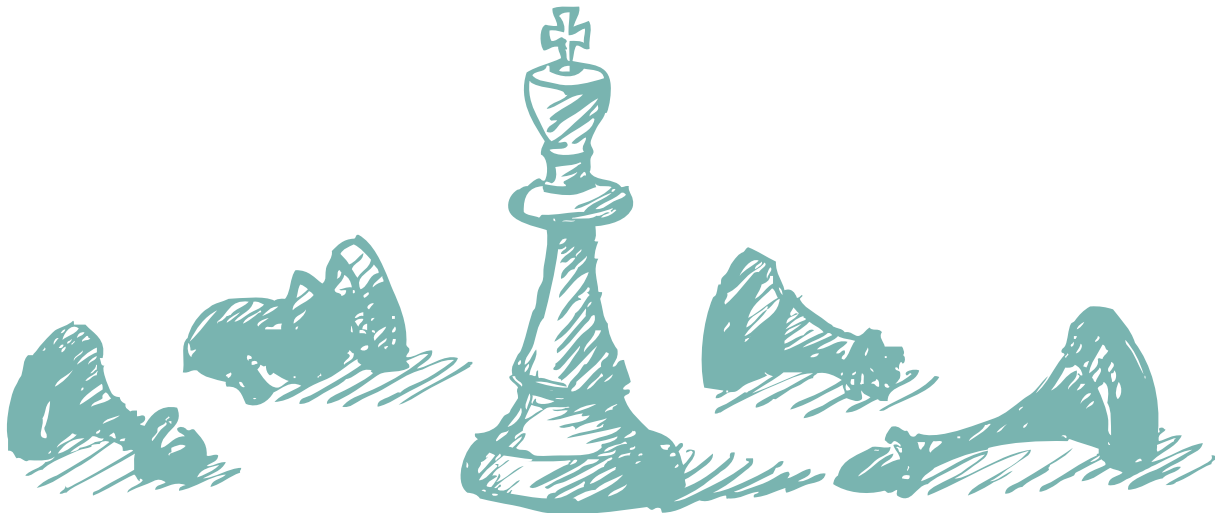
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PENSION INVESTMENT **GOVERNANCE**

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INTRODUCTION

Governance is an important ingredient in both Pay As You Go (PAYGO) and funded pension provision. Governance is the means to create trust, integrity and efficiency. It is the resource that enables an institution to maximise its performance. A well-governed pension fund performs in an effective and equitable way. It delivers added value and needs less attention by the regulatory authorities. A well-governed pension fund is a welfare institution its members can trust in. And, members do need trust to place their money in an institution that promises them a pay-back in the remote future. This holds true especially for low-income workers in the informal sector who face a low level of social protection, are mostly financially illiterate and lack prior experience with pension savings. As Ambachtsheer (2016) points out, good pension design, good pension governance and good pension investing need to be well aligned to make funded pension provision work well for the many people who entrust their savings to them.

The over-riding purpose of a pension fund is to provide retirement benefits to their members. We observe many different organisational structures with different plan designs and different sets of stakeholders, which we will summarise later in this section. But notwithstanding the organisational structure, investment is a core function at pension funds. Pension funds collect contributions, invest the money in (global) financial markets and finally pay-out pension benefits. These are long-term concerns, supported by the mechanism of compound interest. As pensions are accrued over long periods of time, one percentage of additional performance (net of fees) translates into approximately 20-30% higher pension benefits or alternatively 20-30% lower costs. Investment decision-making needs to be well governed. The formal mechanisms by which an institution makes decisions, is held accountable to its stakeholders and beneficiaries, and acts in accordance with public and private standards (Clark 2004), have a significant impact on how well the institution achieves its target.

This chapter is organised as follows: It first sets the stage by explaining the concept of governance in the broader organisational context of the pension institution, and, then focuses more closely on the investment process in terms of pension investment governance. It will lay out the theoretical framework, drawing mostly on the seminal paper from Jensen and Meckling (1976) in order to provide a deeper understanding of the principle of conflict of interest and the information asymmetries fundamental to the importance of governance. Second, it will summarise the principles of best-practice governance as developed by a wide range of authors from Ambachtsheer, Clark, and Urwin, through to the International Social Security Association (ISSA) and the work of many practitioners collaborating on this volume.¹ Theory will be followed by practical experience. Third, the chapter will provide evidence from both developed countries and the developing world. In doing so, it aims to provide examples of good governance

¹ See for example Price, Ashcroft, and Hafeman (2016) and Ashcroft, Inglis, and Price (2016), ISSA (2013) and International Organization of Pension Supervisors Risk Based Supervision Toolkit.

or experience to show which should be avoided. It tries to derive insights and best-practice principles based on the long-standing experience of the developed world with funded pension provision that can be transferred to the developing world. In doing so, it recognises the significant differences in the two settings. Finally, it draws some conclusions of potential applicability to pension inclusion initiatives.

GOVERNANCE IN CONTEXT

The following section sets out the theoretical issues of the principal-agent conflict and regulatory approaches to help resolve inherent problems. It further describes various governance models pension funds apply and sets out the key elements of best-practice pension governance.

THE PRINCIPAL-AGENT PROBLEM

The starting point for considering the nature of good governance is to consider how it enables the institution to overcome the principal-agent problem² that is inherent in all organisations that are characterised by delegated decision-making (Ross 1973). As the members of the pension fund (the principals) are unable to manage the pension fund themselves, pension fund managers (the agents) are engaged to perform this task on their behalf, which in some jurisdictions, are formally recognised as trustees. In any event, the agents shall act in the best interest of the principals. The pension fund managers have delegated decision making authority. Moral hazard results when the management does not act in the best interest of the principal. The problem is that it cannot automatically be assumed that an agent will always seek to maximise the welfare of his principal rather than his own. This is partly a problem of monitoring as the principals cannot properly observe the actions of the agent. This holds true for the active, deferred, and retired members of a pension fund whose level of financial literacy is mostly low and understanding of pensions or investment very limited, in both developed and developing countries. Furthermore, asymmetric information between the principal and agent gives rise to adverse selection.

To resolve the potential principal-agent conflict, incentive mechanisms need to be implemented to properly align the decisions of the agent(s) with the interests of the principal(s) and an authority needs to be installed which can monitor the agent(s). This task can be performed in principle by any legal entity that is separated from the decision-making of the pension fund. One standard form of mitigation is the two-tier model of governance in which the operational and oversight responsibilities of a pension fund are identified and separated (OECD 2009). In pension funds, the board of trustees (or other form of top-level board) assumes the oversight responsibility while the pension fund management is responsible for fund operations. But, this assumes that there are effective mechanisms to ensure that the top-level board's oversight is effective and decisive.

² See Jensen & Meckling (1976).

A pension fund is, like any company, an institution, which can be seen as a web of contracts allocating property rights. Contract theory assumes that individual behaviour is informed by contracts. Some claims have priority over other claims. The residual claimant is the stakeholder whose claims are only settled after the legal claims of all other stakeholders. In an employer-sponsored plan, the employer has the position of the residual claimant under-writing the pension promise, which for a Defined Benefit (DB) plan, can be a heavy burden, either as a legal obligation for full contractual discharge, as in the U.K. and USA, or as a partial legal obligation coupled with a moral obligation and often societal expectations as they are obliged to settle the final bill.³ If they have to pick up any shortfall, then in theory, the employer has a strong interest to monitor the pension management to make sure the investment is efficient but risk-controlled, while administration costs are low, primarily by appointing governing board (trustee) members of sufficient diligence and expertise. The ability of employers to be effective in protecting their interests in this way is, however, variable.

But, in many pension arrangements, property rights are often diffusely distributed between different groups of stakeholders whose interests may diverge. The Netherlands have established a set of rules to clarify the pension deal. Under a collective defined contribution arrangement with fixed employer contributions, potential loss-taking is distributed between active and retired members. When the solvency ratio of the pension fund falls below a defined level, accruing rates and pensions in payment have to be cut following ex-ante defined and communicated rules. On the other hand, Defined Contribution (DC) plans with minimum guarantees, but decision-making by the individual, might give rise to speculation or conservatism depending on the risk attitude of the individual. DC plans without guarantees, where any losses are borne directly by the individual member, but with collective investment decision-making by the management of the pension fund, place very high demands on governance and control because of the poor alignment between the principal's interests and the agent's incentives.

Where for-profit corporate funds are concerned (and many DC plans are of this kind), one approach has been to rely at least partly on the disciplinary forces of the markets. Pension systems in Latin America and Eastern Europe were therefore designed with strong competitive elements in their pension systems, while Australia introduced fund provider choice. The theoretical case is built on the assumption that members of such individualised DC systems will switch funds in case of under-performance and thus provoke an optimal result. A high level of financial literacy is required to make decisions that are in the best long-term interest of the individual, especially if the individual is required to choose an optimal portfolio between many options. There have been plentiful examples of excessive intermediary costs and mis-selling, as well as poor choices governed by behavioural biases and low financial literacy. Research in Latin America (Berstein 2002, amongst others)

³ In the USA, the Employee Retirement Income Security Act (ERISA) requests that the sponsor of a terminated single-employer plan pays the Pension Benefit Guarantee Corporation (PBGC) the amount of any unfunded benefit liabilities (ERISA §4062). But in many countries with Defined Benefit systems, the employer does not always have a legal obligation to pay all the benefits even if there is a shortfall in assets – but do so as part of custom and practice. When there is a major event, such as a bankruptcy or a major financial crisis, it then becomes clear that there are no actual legal requirements to make good the shortfall.

has shown that intense and expensive sales effort by intermediaries is needed to induce significant switching. Furthermore, competitive pension fund systems with high switching options for members have been found to provoke herding behaviour on behalf of the involved commercial asset managers, as well as requiring additional liquidity.

Even if competition were to provide effective discipline over pension fund managers (agents), which has increasingly shown to be doubtful and not cost-effective, it has no relevance in pension systems that give members no choice. Members of the traditional employer-sponsored DB pension funds, which are often mandatory for employees, cannot just ‘walk away’ in case of mis-management, and hence no reliance on market forces to ensure good performance could even be contemplated. Some other way is need to ensure over-riding fiduciary responsibility.

REGULATING GOOD GOVERNANCE

From the previous section, it can be seen that there is no certain resolution of principal-agent risks without some effective monitoring from outside the pension funds themselves. Hence, the need for sound regulation is undisputed, especially given the long-time horizons involved in pension provision and the societal need for consumer protection, and hence pensioner welfare. Not surprisingly, the regulation of governance has become one of the leading principles of pension fund regulation – not only across the OECD but increasingly in developing countries – not least as a result of the sharing of best practice on successes and failures in pensions from a range of organizations from the OECD, International Organization of Pension Supervisors (IOPS), World Bank and the Toronto Centre for Global Leadership in Financial Supervision.

In trust law countries, such as the United Kingdom, the United States and Australia, the guiding principle of fiduciary responsibility is enshrined in the long-established law of trust. A pension fund is legally a trust guided by trustees. Trustees are requested to act in the best interest of the beneficiaries and are bound by the highest standard of care known as a fiduciary duty standard.⁴ The principle of prudence governs the investment decision making of fiduciaries (Vine 2010). This principle of moral suasion is usually underpinned by the power of law. Comprehensive pension laws and regulation supplement and elaborate on trust case-law. For instance, in the U.K. the Pensions Act 2004 clarified that individual trustees should have sufficient knowledge and understanding whereas some pension funds had assumed that it was enough for the board to have such knowledge and understanding corporately.

Especially in the United States, courts can rule harshly in cases of breaches of fiduciary duty – although it can also be very challenging in practice to take a case through the courts. Often, cases are settled outside court. Recent years have seen an increasing number of law-suits focussing on excessive fees in 401(k) DC plans. In 2015, for instance Boeing

⁴ In the US, the Employee Retirement Income Security Act (ERISA) requests that ‘a fiduciary must discharge his or her duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and aims’ (ERISA §404(a) (1)(B)).

and Lockheed Martin paid USD 57 million and USD 62 million respectively to settle lawsuits in which employees accused the companies of mis-managing their retirement plans. The extensive and long-standing case law regarding fiduciary trusts has a strong disciplinary impact on trustees that affects decision making, including on investment.

The establishment of fiduciary responsibility for governing boards is limited to explicit legislation in civil law countries found in Continental Europe and Latin America. When neither the legal structure of a trust nor the principle of fiduciary duty is embedded in legal history, equivalent legal requirements need to be implemented. It has been very much a trend, encouraged by OECD Principles for such frameworks to seek to find a country-specific way in which to achieve the same long run aims of good outcomes from well-run pension institutions. This often involves focusing on the licensing, regulation, and supervision of those running pension institutions. For simplicity, the language and concepts of a trust overseen by a board of trustees guided by fiduciary duty are often used here, recognising that similar intentions exist, and are regulated for, in civil law countries – with a Governing Board/Managing Board distinction often used to distinguish different roles.

THE BOARD OF TRUSTEES⁵

Trustees carry a broad responsibility for the pension fund including that investment accords with their fiduciary responsibility: They are hence responsible for determining the mission and beliefs of the pension fund and ensuring that an effective investment governance model is implemented. This requires them to be able to answer questions like: What is the long-term goal of the pension fund? What is the vision for the pension fund in 30 or 40 years? The fund's liabilities and status will help provide the guidelines to the answers. Mission and beliefs of a mature pension fund which is closed to new contributions and is planning for the end game will be fundamentally different from the mission and beliefs of a young and going concern pension funds with an indefinite time horizon. Plan population and time horizon are also the starting point for the development of the investment beliefs (in DC as well as DB funds).

The trustees are further responsible for the strategic asset allocation of the pension fund and managing investment risks, often through a risk budget. This role is often delegated to a specialised investment committee of the board. The board should not be responsible for the implementation of the investment strategy, although they should monitor it, and are responsible for choosing asset managers. Portfolio construction and reporting are the responsibility of the management of the pension fund if the investment process is managed internally or otherwise it is the task of the external asset managers. But the responsibility for the high-level policy decision remains with the board. Questions like, should the fund invest internationally (if permitted by regulation), should it invest in equity and to what extent, and how much risk can be taken, need to be jointly agreed. It is good

⁵ The primarily Anglo-Saxon term 'board of trustees' is used in this chapter, but this is interchangeable with any entity overseeing the management of a pension arrangement – for example the Governing Board compared to the Managing Board. In a one-tier-governance system management and oversight are blended into one function. In any event, good practice requires that governing board members act as de facto if not de jure trustees.

practice, and in most countries a regulatory requirement, to have these broad guidelines articulated within a written Statement of Investment Policy, or Principles, which is regularly reviewed, preferably annually.

So, how can the system be regulated to ensure that the board of trustees properly performs this important function? The board of trustees needs adequate representation to gain legitimacy and trust. It is good practice to have trustees representing the different stakeholders of the pension fund. This often includes trustees representing the members who may be elected at a general meeting of members. In many cases, such as the Netherlands, there can be specific representatives of the retirees on the board. In employer-sponsored and financed plans, the sponsoring employer usually appoints one third or even a half of the trustees. An increasing trend in the United Kingdom is for independent trustees, who may be investment professionals, to be appointed to supplement the board's expertise and reinforce its impartiality.

The next requirement is for the trustees to apply the strategic oversight over the pension plan. This demands knowledge, expertise, and competence on behalf of the trustees. Not every trustee needs to be an investment professional, but they need sufficient understanding of the issues to manage and control their investment professionals, whether this might be external or internal asset managers. This profile of qualifications can be – and often is – at odds with the requirement of representation. Especially in pension fund systems, which had historically been built on lay (or non-expert/member representative) trustees, the necessary professional expertise of trustees can be a challenge. Indeed, the Kenyan regulator has gone so far as to make passing a specific trustee qualification a condition of remaining on a trustee board, while the U.K. regulator offers an on-line trustee training tool-kit and has in addition the power to remove trustees considered as not fit for purpose and to replace or augment them with their own nominees. In the Netherlands, the regulator has been proactively interviewing and assessing existing trustees, some of long-standing, to see if they are fit for the higher standards to which the regulator aspires. If they are not, then they are no longer allowed to act as a pension fund trustee.

Particular issues may arise where government representatives are included on the board of trustees. In any public pension system, the government is a legitimate stakeholder being the plan sponsor and probably a major contributor. A government also has interest in funds enabling the achievement of governmental welfare objectives, and hence their representatives could be legitimate members of a board of trustees. In principle, the requirements for governmental appointed trustees should not differ from the requested qualifications of all trustees. In practice, shortcomings in public plans' governance have been found (Fitzpatrick and Monahan 2015, Impavido 2002, Useem and Hess (2001) that resulted in underperformance (Andonov et al 2016, Iglesias 2000). There are some reasons why a government representative may not be well suited to perform as a pension fund trustee as: (1) it has law-making powers and is thus able to escape control; and (2) usually has a broad and economically conflicting agenda.

On the other hand, there are many examples of well-managed public pension funds with excellent performance, as for example the large Canadian pension funds or Norway's Government Pension Fund. The Canadian model operates with a governance structure that is insulated from the political process with an independent and professional board. The Norwegian fund on the other hand is an example of a public fund managed by the central bank, thus fully integrated into the political system, but with strict governance procedures and controls (Rozanov 2015). Also, the DC fund of the Federal Civil Service – known as the Thrift Saving Plan is probably the world's most efficient pension fund (with all in costs well under 10 basis points or 0.1% of assets under management a year) and an enviable reputation for governance. As shown in the chapter in this volume on Costs, the strongest net of fee performance in the CEM database up to 2016 shows that the strongest performers can be public pension funds. There is a broad range of examples from both the developing and developed world as we will demonstrate in more detail in the next section.

To ensure that public funds achieve or surpass the performance of their private sector counterparts, the challenge is to ensure that the right mixture of legitimate representation and proficient decision-making is found, while avoiding a detrimental politicisation of the institution and its processes or operational decisions.

INVESTMENT BELIEFS AND RISK MANAGEMENT

Pension funds are usually conceptualised as long-term investors. A going concern pension fund has to invest the assets with the goal of paying pension benefits over the next decades. There is widespread belief that for these reasons pension funds can invest in asset classes with a higher short-term volatility but higher long-term returns such as equity and in illiquid assets such as infrastructure. This statement needs to be caveated: The idea that the long-term investor can 'take a hit' in short-term volatile markets draws on the concept of mean-reversion of financial markets, especially stock markets, on which investment theory and evidence is mixed. Financial economic theory whose domain it is to provide investors with investment concepts and strategies unfortunately does not provide unambiguous solutions (Orszag and Sand 2006). A related key question is whether the higher expected returns of non-bond asset classes justify the additional risk. In the USA, the debate whether the Social Security Trust Fund should be invested entirely in bonds or diversify into equity and beyond has been led over decades. The fund still invests entirely in bonds. These contentious issues strengthen the importance of board clarity regarding investment beliefs and good governance more generally.

The board of trustees needs to take a view in particular on whether:

- They believe in the out-performance premium net of fees of active asset management or consider that low-cost passive investments deliver a more reliable net return, or indeed chose different styles for different asset classes. Often, pension funds use passive investment in deep and liquid markets where due to price-efficiency, outperformance may be very difficult to achieve, but use more active management in

smaller markets or particular asset classes such as real estate and private equity, that are less transparent.

- They should out-source the investment function to professional external asset managers or seek instead to build investment know-how and competency in-house, or a mixture of the two.

The optimal answer to these questions is usually closely related to the size of the pension fund. Internal investment has been found to be significantly cheaper than out-sourced solutions but the former is economically viable only at a certain size of assets under management (see in particular Chapter 18 on Costs for a detailed examination on this point). Investment expertise is an expensive and scarce resource. Only large funds have the financial resources to cover all asset classes themselves. Many U.K. pension funds have traditionally outsourced the complete asset management to external managers, which are selected on the advice from investment consultants. Often, core asset classes are covered within the fund but satellite asset classes such as alternatives are out-sourced to specialised asset managers. Dutch pension funds with assets of less than EUR1bn work entirely with outsourced solutions. Fiduciary investment solutions are also becoming much more common with the pension funds in the U.K., which rarely have sufficient size to gain economies of scale. On the other hand some of the largest U.K. pension funds have robust internal investment operations.

In any event, the governance model must be well aligned to missions and beliefs. Internal investment functions require the necessary investment expertise both at the level of the fund management and at the level of the board for strategic supervisory purposes in cases where a two-tier system is implemented. It would not be prudent to extend investments into complex asset classes when there is no adequate knowledge in the fund.

Intrinsically tied to the Statement of Investment Policy is the risk budget framework. Investment risk needs to be permanently managed and controlled. Asset-Liability-Management is today a basic and essential risk management tool for DB plans and, in a modified form being adopted by DC plans. At large institutions investing tens of billions of US Dollars on global financial market, risk management becomes a highly-sophisticated exercise often involving explicit risk consultants or operating sophisticated risk models in-house. But even a small fund with a limited number of asset classes which are totally or mostly invested locally, needs to clarify its risk bearing capacity and its risk appetite. How much money can the fund afford to lose in the short term? This is the very basic question underlying the Value-at-Risk (VaR) concept which is used extensively in risk strategies, alongside other strategies from Conditional VaR and non-parametric techniques that aim to move away from standard statistical models. Who takes responsibility for a loss? How is this communicated to the members? And if they decide not to take an investment risk: What are the consequences of this decision for plan members in terms of their future pension benefits? Can the members afford not to take investment risk?

INVESTMENT GOVERNANCE MODELS

Pension investment governance is the key resource to improve pension fund performance measured as long-term risk-adjusted rate-of-return. Delivering excellent performance is the responsibility of the management of the pension fund and its supervisory board. Pension funds organise themselves in many different ways, informed by their respective legal and regulatory framework. We can find a broad range including all combinations of in-sourced and outsourced organisational forms observed at small and large pension funds. We focus here on three distinct models of pension fund investment governance and elaborate on further forms of collaboration.

THE HUB-AND-SPOKES MODEL

In the hub-and-spokes model of pension fund governance (Clark and Urwin 2016), investment advice, investment management, risk controlling, and performance evaluation are completely or partly outsourced to external agents that need to be managed and controlled. Investment consultants advise the management of the pension fund on the strategic asset allocation that best fits the liabilities of the plan and reflects the investment beliefs of the board, and select external asset managers. A specialised risk manager might consult on the risk management frontier and implement overlay strategies aimed at hedging unwanted risk. The custodian produces the complete reporting including those requested by the supervisor. This is, for example, the most common governance model in the U.K.

The investment consultant is the key intermediary between the trustees as the asset owners and the international asset management firms. This model evolved in the markets and, in the U.K. (at least) it was firmly anchored by regulation that requires pension funds to seek advice on investments. The role of the investment consultant has been subject to some criticism. While some doubt the innovation capability of consultants (Knight and Dixon 2011) others question the added value of consultants more fundamentally based on their manager selection capabilities (Jenkinson et al 2016). It is crucial that the trustees understand this and can critically appraise the advice.

THE INTEGRATED SOLUTION

Large pension funds have increasingly built complete investment organisations in-house. The in-sourcing of pension investment management is a trend that can be observed since at least the 2000s. As the pension funds' size continued to grow, the cost advantage of in-house management has been increasingly recognised. As some asset managers – and in particular hedge funds claiming to offer returns uncorrelated with the market, risk advisers and investment consultants failed to achieve the promised results in the Global Financial Crisis, more institutional investors decided to bypass the traditional intermediaries. These models can significantly reduce the agency problems of the hub-and-spokes model but involve challenging implementation issues. In-sourcing pension investment management requires building a complete investment

organisation in-house. This includes not only the obvious investment function but, equally important, also risk management and performance measuring. Furthermore, it requires a vibrant learning organisation to constantly adjust investment strategies to rapidly changing financial markets and changing expectations from stakeholders and regulators and to innovate the organisational design. Research found this model to be able to deliver out-performance if the necessary best-practice factors, process, people, and resources are in place (Clark and Monk 2012,).

FIDUCIARY INVESTMENT SOLUTIONS

Fiduciary investment, which is also known as the Delegated Chief Investor Officer is an out-sourced investment model that evolved in the Netherlands in the early 2000s and is now becoming more widespread in the USA and the U.K.. It is a concept of managing mid-sized investment portfolios. It can be seen as an alternative to the integrated solution, which is only economically viable for the largest institutions. Under a fiduciary arrangement, the complete investment process is outsourced to one (or more) fiduciary manager who selects and controls the asset managers, is responsible for risk management, and the ever more complex reporting. Only the fiduciary control, the setting of mission and goals, the strategic asset allocation, and the risk budget oversight remain with the pension fund board. The proponents of this approach were initially large pension funds that had separated the pension fund from their pension investment organisation which then took over the investment management for smaller pension funds. Thus, it creates scale, lowers investment costs, and relieves the pension fund from the regulatory reporting duties. Increasingly, investment consultants and international asset managers moved into this new market segment. The management of Chinese walls and of conflict of interests within these organisations is essential.

FURTHER FORMS OF COLLABORATION

Pension funds co-operate at various frontiers. Alternative asset classes such as infrastructure provide a good example for collaboration between pension funds, due to its illiquid and opaque nature, and the large investment requirements of the single projects. Shared investment proves a viable route for pension funds where the minimum asset tranche would otherwise be too large for their investment needs and who do not have the specific research skill to properly evaluate the projects. Co-investment along with fund managers was found to be problematic due to adverse selection biases (Fang et al 2014). Cooperation between peers has become more widespread and more promising. Pension funds bypass traditional fund managers in a drive to lower fees and to better align interests. Pension funds may jointly buy solar or wind power stations. For instance, three Danish pension funds started in 2009 to jointly invest EUR 100 million in renewable energy projects.⁶ One pension fund might have an excellent private equity team that is opened to provide also for other funds.

⁶ Source: <https://www.ipe.com/danish-schemes-invest-100m-in-renewable-energy/33632.article>

Furthermore, platforms for institutional co-investment by pension funds have been set up, some market-led, some government-led. The Global Strategic Investment Alliance (GSIA) is an example of a market-led initiative. It was launched in 2012 by the Ontario Municipal Employees Retirement System (OMERS) for joint investments in infrastructure by pension funds. The Government of the Philippines initiated the Philippine Investment Alliance for Infrastructures Fund (PINAI) with co-investments from large public pension funds such as the Dutch APG to attract private capital to Philippines infrastructure investments (OECD 2014). The boundaries between the traditional suppliers of asset management, investment consultant, and pension fund are blurring.

GOVERNANCE BEST PRACTICE

Increasing attention is being paid to the performance of pension institutions. This holds true for the mostly relatively large public pension funds as well as for the myriad of often very small privately sponsored funds we observe across the world. The trend to move away from reliance on a single public pension pillar to deliver retirement income, and to have a more multi-pillar or tier arrangement that has both public and private pensions elements, is common across Central and Eastern Europe, Asia and Latin America, and many other jurisdictions. This requires a focus on those institutions that produce pension benefits by investing contributions on capital markets. Their performance assumes responsibility for the well-being of many.

As the following section of this chapter shows, governance has been found to be closely related to the long-term performance (net of costs) of pension funds, in a risk-adjusted context. It is undisputed that the investment performance is of central importance in funded pension arrangements. Many studies have confirmed the link between governance and performance, which was first established by two separate research projects in the 1990's led by Mitchell and Ambachtsheer whereas, Clark and Urwin developed the models of best-practice pension fund governance.

In this section the literature is summarised, starting with Ambachtsheer's empirical observation that good governance can increase the risk-adjusted performance of a pension fund by at least one percentage per year (1998) – this translates into 20 to 30% higher pension benefits over the long accumulation periods involved in pension provision. The critical success factors are then identified, following Clark and Urwin (2008, 2010) who conducted an international research project involving case studies on pension funds around the world. Such consideration of best-practice pension governance can be separated into:

- Institutional coherence
- People
- Process

INSTITUTIONAL COHERENCE

The institutional structure of an organisation needs to be aligned to its purpose and tasks. The management of the pension fund needs a clear mission to which all stakeholders are committed. This involves the often very difficult task of clarifying and reconciling often diverging interests of different groups of stakeholders. Hence, the policy of the pension fund must be clearly stated, documented, and adhered to. Clark and Urwin found it very helpful when the general mission, to maximise the welfare of the beneficiaries, is specified with a target of an annual risk-adjusted return. Clear specification and accountability of responsibilities are further characteristics of best-practice governance. War-gaming can be a helpful tool in reviewing the soundness of processes. Notwithstanding whether asset investment is conducted internally or outsourced to an external manager, the pension fund needs a competent investment official, who is capable of selecting, overseeing, and controlling the asset managers. The fiduciary responsibility rests with the pension fund and cannot be outsourced.

PEOPLE

Talent is the most valuable asset in all organisations. Choosing the ‘right’ people for managing and controlling pension funds is of vital importance for the performance of pension institutions. Nevertheless, Ambachtsheer (2007) found that the process and the rules by which pension funds selected management and trustees varied significantly. Clark and Urwin list as best-practice factors: Leadership that has been shown to have a measurable impact on fund performance; Numeric skills; Capacity for logical thinking; and Knowledge in theory and practice of probabilities are preferable qualities for selecting trustees. Competitive compensation of the management and key staff of large pension funds is strongly advocated, although it has become a disputed arena. In some jurisdictions, such as Canada, pension fund management and staff are paid in comparison to the management of large financial institutions, as pension funds compete with asset managers for exceptional investment talent. On the other hand, public pension funds are often seen as part of the government sector with remuneration more aligned to the remuneration of public servants. That said, the Swedish government that oversees large mandatory pension funds that operate as part of the public pension system withdrew a regulation proposing to align the pay of pension fund staff with the public sector in general.

Trustees (and management) must be selected based on their expertise and experience they bring to the board table and their ability to focus on long-run member interest and not based on political connections or other outside or conflicting interests. And, finally, a pension fund needs the required competencies in terms of an educated staff that is effectively paid.

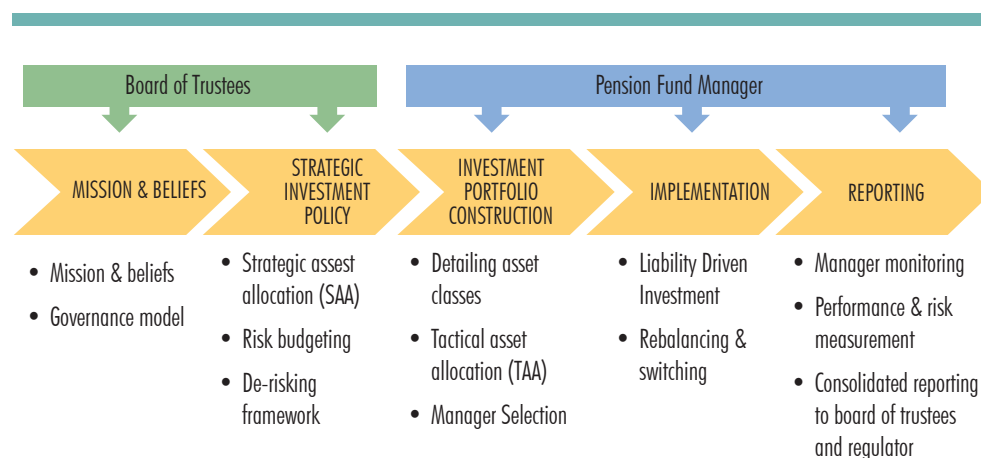
PROCESS

According to Clark and Urwin, once the first two factors are in place, the process of investment decision-making proves to be the most important factor in delivering performance. A best-practice investment process is centred on strong investment beliefs that are shared and supported throughout the institution. It is rather an understanding of temporary over- or under-valuation of asset prices than a belief in the ubiquity of the efficient market hypothesis that enables a fund to find opportunities and to outperform compared to its peers. The selection of asset classes for the portfolio construction depends also on the available skills and knowledge. Knowing your advantages and disadvantages is an important competitive edge. It is not prudent to decide to invest in asset classes for which there are no skills in the pension fund. Good governance requires goals, investment beliefs, and investment decision-making to be well aligned.

Figure 17.1 outlines how the mission and beliefs and objectives should translate into the strategic investment policy and allocation, under-pinned by rigorous analysis and risk management. This in turn translates into portfolio construction, asset class, and investment style decisions together with the selection of appropriate fund managers. They should implement the strategy in compliance with the fund's investment principles (mandate), and there should be objective monitoring and reporting of their performance, which should in turn feedback into reviews of the fund objective and strategy.

Figure 17.1

Schematic of best practice investment governance



Source: Avida International

A quantitative risk budgeting framework is seen to be an essential instrument constraining and controlling the investment decision-making process. At pension funds, investment goals are often formulated in an absolute return context, or relative to the fund's own liabilities if it is a DB fund, and not relative to a short-term market benchmark, which is a more widespread practice in the asset management industry. Aligning the investment

goals of the pension fund with the benchmark customs of asset managers is an important exercise. Effective control of external asset managers who have been given a clearly defined mandate is a further best-practice factor. These asset managers should report in a cost-transparent and control-enabling way – something that can be very challenging to do and requires very clear and full cost disclosure that might need regulatory backing. Furthermore, the high volatility of international financial markets requires fast decision-making that can be at odds with long-term fixed board meeting schedules. Up-front agreed contingency plans that can be implemented by the management without further authorisation have been found very helpful, as has out-sourced fiduciary management. Finally, innovation and thought leadership characterises best-practise institutions.

EVIDENCE FROM DEVELOPED COUNTRIES

The correlation of pension fund governance with net investment returns has been the subject of some considerable research in recent years, primarily using the databases of investment portfolios and performance created by CEM Benchmarking Inc. (reviewed extensively in Chapter 18) and the Australian Prudential Regulatory Authority (APRA). The CEM database includes data, some dating back as far as 1990, from over 900 large globally selected pension funds and other institutional investors with aggregate assets exceeding USD 8 trillion. The APRA database covers all the nearly 400 significant pension funds in a series going back to 1996 (although recently modified) with assets, now, of some USD 1.5 trillion. Both, therefore, provide large enough samples for robust research.

The already earlier cited study (Ambachtsheer and Ezra 1998) of the governance practices of 80 North American pension funds compared performance from the CEM database to statements regarding governance practices made by senior pension fund executives in response to a research survey. Their research demonstrated “...a positive correlation between proxy metrics for pension fund governance quality and for pension fund performance. High-quality funds outperformed low-quality funds by about 1% per annum”. They also identified a number of specific fund oversight and management factors as important performance drivers, and in particular were concerned about the effect of poor scores for a haphazard trustee selection processes, no trustee self-evaluation processes, lack of delegation clarity between the board and management, and board micro-management. Interestingly, performance correlated better with general governance statements than with more specific investment governance process statements. However, there is the possibility of some bias, since the better performing funds might rate themselves better governed.

Analysis of the findings of a 2005 follow-up survey on pension fund governance (Ambachtsheer, Capelle and Lum 2006), to which an international group of 88 senior pension fund executives responded, compared the responses with net value added data

from the CEM database. This again gave a generally positive statistical association between governance quality and net investment performance. This time the analysis suggested that the ‘poor-good’ governance gap could be ‘worth’ as much as 1-2% of additional return per annum, as measured by CEM. They found also a positive correlation with expenditure on fund costs allocated to the internal governance, management, and control. In essence, high-scoring funds spent an average four basis points more per annum on the internal governance, management, and control functions than low-scoring funds

Another study in 1996⁷ had already used the database to show that there were strong positive correlations between net performance and pension fund size, a finding confirmed by other studies, and there was also a positive correlation with the degree of passivity, a conclusion that since has become more nuanced by further research.⁸

Another study (Dyck 2011) used CEM data for 1990-2008 covering 370 pension funds across the USA, Canada, Australia, and Europe split into five size-related quintiles with the smallest being assets under USD 340 million and the largest with assets over GBP 33 billion. Their findings included:

- Larger plans outperformed smaller plans by 43-50 basis points per year in terms of their net abnormal returns, defined as gross returns minus actual costs minus plan-specific benchmarks for each detailed asset class.
- Compared to the smallest quintile, the largest quintile plans deployed 39% more of their assets using approaches other than external active management. Hence, large plans manage 13 times more of their active assets internally, which lead to substantial cost savings. While delivering similar gross returns, external active management was at least three times more expensive than internal active management. But, other factors were needed to explain more than half of the positive economies of scale.
- Larger plans shift towards asset classes where scale and negotiating power matter most and obtain superior performance in these asset classes, in particular devoting significantly more assets to alternatives, where costs are high and where there is substantial variation in costs across plans. The authors’ regression estimates suggested that the greatest impact of size came from the private equity and real estate components of alternatives, where a move from the smallest to largest size quintile is associated with a 6% and 4% increase in net abnormal returns per annum, respectively. There was evidence of positive economies of scale in both gross returns and costs for both private equity and real estate.
- Finally, they found that stronger governance provided higher returns and a greater ability to take advantage of scale economies.

⁷ Summarized in Ambachtsheer “How all pension funds should be measured” Ambachtsheer Letter #130 November 2006 KPA Advisory Services Toronto

⁸ Analysis presented by Mike Heale of CEM in 2011 of a 21-year series across the CEM database showed that active management produced a small but significant net out-performance relative to passive, of 12 basis points a year. As this effect is smaller than recorded scale effects, for instance, the same showed that for a ten-fold increase in size, net value added increased by 18 bps, it might be reasonable to infer that active management is likely to be worthwhile only above a certain scale. See further consideration in Chapter 18.

In essence, the research confirmed the benefits of scale, suggesting that this partially arises from the plan's ability to employ more cost-effective internal management of active investments and efficiently undertake investment in expensive to manage but lucrative alternative asset classes. The larger the plan, the more it can afford to harvest liquidity premia and exploit expert knowledge. Once again governance and performance correlate. Another study suggested that effective internal management increases gross as well as net risk adjusted returns (Koedijk, Slager and Bauer 2010)⁹.

It should be noted at this point that most pension funds on the CEM database are not-for-profit defined benefit occupational funds, with a captive market. There is significant evidence that such funds out-perform mutual funds, which have none of those characteristics¹⁰. Research using APRA data in Australia raises similar issues with the commercial mutual fund type model. A 2012 study (Cummings 2012) computed gross risk adjusted rates of return, investment expenses and operational expenses for 280 DC pension funds across the not-for-profit and retail (i.e. for-profit) sectors during the period 2004-10. The analysis showed that for the not-for profit sector, there was a small but statistically valid correlation between the three larger fund size quintiles and gross investment returns and larger inverse correlations with the two expense measures.¹¹ There were stronger correlations between size and net returns. No such statistically valid correlations were found for retail funds, which across all quintiles had lower gross investment returns, higher investment fees and higher operational fees than not-for-profit funds.

There could be several explanations for the lower gross (and net) investment performance of retail funds. The same research team had already found that not-for-profit funds had on average allocated more of their portfolios to illiquid assets than retail funds (Cummings 2011). Not-for-profit funds with more illiquid investments experienced higher risk-adjusted returns, which suggested that they captured a return premium for investing in these assets. Allocations reflected fund size, net cash inflows and member age - factors relevant to a fund's liquidity requirements. Furthermore, the allocations reflected the extent of the fund's in-house investment management. Reasons for lower allocations (and higher costs) could include differences in participants, with retail funds having to compete (at some cost) for new business and not enjoying the loyalty arising from the linkage to an employer sponsor of not-for-profits. Hence, there is a greater likelihood of participants switching funds, which would increase liquidity requirements. The older age profile of retail funds may also result in less adventurous investment. On the other hand, the absence of a scale correlation may well be evidence of an agency problem or that marketing costs increase with scale.

⁹ For instance, Bauer (2008) showed that over the period from 1996 to 2004, the Canadian equity components of Canadian pension funds out-performed their Canadian equity market benchmark by an average +1.2% per annum, net of expenses. Over the same nine-year period, Canadian equity mutual funds with domestic mandates under-performed their Canadian equity market benchmark by an average -2.6% per annum, net of management fees, but before any applicable sales charges, which would reduce mutual fund net returns even further. Chapter 18 refers to further relevant evidence.

¹⁰ Funds in the largest quintile had assets in excess of AUD 3 billion. Funds in the third quartile had assets below AUD 1 billion.

¹¹ Except maybe for operational expenses which did appear to fall with size, although not so smoothly as for not-for profit funds.

It is unclear from the evidence how much of the performance differential in Australia relates to differences in fund governance and how much to the market structure. In other words, have sub-optimal features of the market reduced fund net performance, has governance done so or has it been a combination of the two? That the market has been sub-optimal was presented very clearly in the 2014 ‘Murray’ report (Australian Government, The Treasury 2014) which concluded from research evidence that *“substantially higher superannuation [DC pension fund] balances and fund consolidation over the past decade have not delivered the benefits that would have been expected; these benefits have been offset by higher costs elsewhere in the system rather than being reflected in lower fee”*. This research too found that over the past 10 years the for-profit retail funds consistently performed worse than the different types of not-for-profit fund. The not-for-profit funds¹² outperformed the retail for-profit structures by on average around 150-190 basis points a year. Market forces within the for-profit market were not leading to lower costs being passed on to members due to the well-known problem of the lack of an effective demand side in mass market private pension provision.

Other APRA research (Sy 2009) found evidence of persistency of superior investment performance across 115 Australian DC pension funds in terms of risk-adjusted value added. This ability of some funds to persistently out-perform others appears to provide evidence of linkage with governance. The study also showed that higher operational costs correlated significantly with lower net investment performance, which one might expect to be un-correlated. This suggests that general governance quality, as a driver of operational efficiency, correlates with investment performance.¹³

That the governance of commercial fund managers may be sub-optimal is supported by a study (Sy 2008) which took as a given other APRA research evidence that retail funds have higher fees than other types of fund,¹⁴ and explored differences in their governance arrangements found from a survey of trustees. The findings included:

- Retail trustees spent much less time undertaking their functions.
- Most non-profit trustees performed the investment fiduciary duties including portfolio construction, whereas for-profit trustees within conglomerate structures mostly passed the portfolio construction task to related executive fund managers, related financial advisors or individual pension investors themselves.
- Retail funds are much more likely to use service providers that are related parties, and often had investment managers as executive directors on their boards, impairing the negotiation of best terms for investment management services.

¹² Note that not-for-profit effectively describes the long-term objective or orientation of the funds — they can and do contract with the private sector for services.

¹³ The authors ascribed the finding to the possibility that pension funds with higher visible costs also had higher hidden investment costs, for instance, from sources such as investment returns declared net of costs to the fund by hedge funds or funds of funds.

¹⁴ For instance, Bateman (2001) found that retail fund costs were around 50% higher on an assets under management basis than was the case in other types of fund.

- Trustee directors of retail funds were much less likely to save with their own funds than other trustee directors.

Research into performance data for 1999-2010 from Polish DC pension funds (Jackowicz 2011), which are subsidiaries of financial institutions, showed that boards with independent (outside) board members were associated with improved pension fund performance.

The annual survey of pension fund governance undertaken by the Pensions Regulator in the U.K. has repeatedly found a correlation between attributes of good governance (such as frequency of board meetings) and fund performance (self-assessed and through metrics such as documenting internal controls and reviewing risk management) – although not actually the fund returns themselves. In the 2014 report found that scale also correlates with fund performance as well as with specific aspects of good practice such as with managing conflicts of interest and obtaining formal assurance reports on out-sourced fund administration, and trustee knowledge and understanding.

In summary, developed world evidence highlights the importance of pension fund scale, the design of the pensions market and governance.¹⁵

- Scale is a necessary requirement, first, to construct highly diversified portfolios and, second, to replace expensive external asset management with in-house teams which in turn requires professional investment expertise. Furthermore, investment, administrative and operational unit costs, all of which can decline with scale, can have a significant impact on pension benefits. Scale can also correlate with governance quality.
- Funds that are obliged to compete for participants often incur high sales costs to achieve the aspired penetration. In some countries, such as Switzerland and the Netherlands, the regulatory authorities have requested pension funds to detail their investment costs per asset class. Large funds with highly-diversified portfolios incurred up to 80% of their investment cost in illiquid asset classes such as private equity, real estate and infrastructure. Cost opacity by asset managers induced some funds to restructure their portfolios. The for-profit (and mutual fund) model brings with it the further risk of conflicted or non-aligned interests, which may deflate net investment returns, although this risk may be mitigated by the presence of independent directors.
- Finally, good governance, as already defined, can result in substantial out-performance of less effective governance, as indeed can investment in good governance.

A key question, however, is the applicability of this evidence to less developed markets which tend to have significantly different attributes. Developed market pension funds are more likely to be employer sponsored, hence with captive markets, and governed by fiduciary trustees or directors. While there may be many small funds, experiencing issues

¹⁵ For example see Bicker (2011)

from lack of scale, the funds subject to research are mostly relatively mature and large. Pension funds employ specialist asset management companies, partly complemented or completely substituted by internal fund management if large enough. Developed market pension funds have readily accessible, deep and liquid financial markets, limited regulatory restrictions on investment and in general good availability of investment professionals. Sophisticated investment strategies and risk management techniques are available). Figure 17.2 illustrates their investment environment.

Figure 17.2

The developed world investment environment

ORGANISATIONS	INVESTMENT PEOPLE	INVESTMENT PROCESS
<ul style="list-style-type: none"> • High diversity of historical grown pension fund systems • Often diffuse pension arrangements • Recent restructuring: <ul style="list-style-type: none"> » Gaining scale » Improving performance » Lower costs for employer • Retreat of the employer, stronger involvement of state 	<ul style="list-style-type: none"> • Traditionally: <ul style="list-style-type: none"> » Often laymen instead of professionals » No or low compensation • Increasingly: <ul style="list-style-type: none"> » Retreat of lay persons » More investment professionals » Efficient compensation 	<ul style="list-style-type: none"> • Traditionally: <ul style="list-style-type: none"> » All forms from complete inhouse management to completely outsourced investment • Increasingly: <ul style="list-style-type: none"> » Outsourcing to professionals (fiduciary management) » Stronger focus on risk management » Faster decision-making

Source: The authors

THE DEVELOPING WORLD'S GOVERNANCE AND INVESTMENT ENVIRONMENT

The developed world environment has significant differences from those found in most of the countries covered by this book. While some of the countries have the concept of not-for-profit fiduciaries (trustees), employer sponsorship of (as opposed to contributing to) pension funds is limited and falling, often being replaced by extensive State involvement in establishing and regulating pension systems (although greater governmental involvement is seen in some developed world countries too) as they try and move beyond the outcomes achieved only with a voluntary private pension market. The developing world funds use a very wide range of approaches from DC individual accounts (e.g. Mexico) through to individual accounts with a return guarantee (e.g. Malaysia), through to continued DB provision in employer based plans, which are often still large due to their longevity

(e.g. Egypt). Governance ranges from trustee-based, sometimes excellent, sometimes with competence issues, to commercially-based with the potential for conflict issues. The investment function in commercial pension fund management companies is often vertically integrated and small, managing relatively lesser amounts of assets. But there are also examples of an ‘unbundled’ architecture with fund managers separate from administration (e.g. India) and of large not-for-profit pension funds with strong in-house management capabilities, e.g. Malaysia and Oyak in Turkey.

Furthermore, in the earlier stages of pension system development (at least) domestic financial markets have tended to be thin, shallow, and illiquid, while access to global markets has often been limited by regulation, ‘patriotism’ or concerns about un-hedged foreign exchange exposure resulting in simple un-diversified investment strategies. Consequently, (see for instance Iglesias 2000) the value-added has sometimes been minimal, with negative real rates of return common. On the other hand many countries, or well-run funds within countries, have seen very strong real rates of return that are in excess of those seen in developed countries – with Chile and Mexico for example having consistently shown strong returns.

Other problems have arisen from pension market structure and design in various developing countries. For instance:

- Excessive activity by sales agents has increased the costs of pension systems and participant churn, which in turn can substantially increase liquidity requirements. As an extreme example, in Costa Rica the churn climbed to around 10% of participants switching the fund provider each year before regulatory intervention reduced the attractiveness of the market for sales agents – an action that was shortly followed by fee reductions reflecting consequential cost reduction. The effects have been less dramatic elsewhere, but other countries with similar pension systems experience higher costs and liquidity requirements due to sales agent activity.
- Where there is limited restriction on exit prior to retirement, this has substantially constrained the ability of pension funds to utilize longer term investment strategies, or less liquid investments. For instance, in Turkey participants can withdraw money from their fund after just six months, and the average duration is only three years. This has placed substantial liquidity requirements on the funds, which are inevitably short term focused, depressing net investment returns to a level currently lower than bank deposits.
- Regulatory minimum return guarantees, as found, for instance in Slovakia and Slovenia, have had the effect of driving investment towards low volatility and low return strategies – indeed the introduction of guarantees in Slovakia was followed immediately by divestment in equities.
- Even where penalties for low returns have been related to the average performance of pension funds rather than an absolute target, as is the case of some Latin American countries, they have affected investment behaviour by encouraging herding behaviour.

While good quality governance could potentially mitigate the effects of constraints on investment performance imposed by the system, or its regulation, it would evidently be beneficial for the structures established to support expanded pension to avoid the types of problems referred to above. Developed world evidence that could be particularly relevant includes:

- The value of good governance in driving performance along the complete value chain from investment up to reporting and administration.
- The importance of scale to enable better access to investment expertise and in lowering unit costs.
- Bearing in mind that the scale available to pension inclusion projects is likely to be insufficient to make in-house expertise cost-effective, at least early on unless an already existing structure is used, ensuring that investment expertise is available and applied through out-sourcing that is undertaken and monitored by a board and executive with sufficient expertise to act as an intelligent customer.
- Enable and encourage long-term focused strategy – minimise design features that apply liquidity constraints.
- The agency risk evident in ‘for-profit-structures’, which leads to a conclusion that ‘not-for profit’ structures are to be preferred where feasible, or at least that for-profit fund boards should include an independent board member.
- Costs and fees should be restrained (or at least very closely monitored) but not at the expense of real rates of return or the governance budget.

Governance theory and experience would indicate that the pension funds for pension inclusion initiatives should ideally have a two-tier structure comprising:

- A top-level fiduciary board responsible for oversight and strategic direction, including investment strategy.
- An executive, maybe with a committee structure, responsible for managing operations, which may well out-source functions so as to take advantage of the expertise and scale available in the market.

How far a jurisdiction or initiative can move in this direction depends on local circumstances. In particular:

- The governance arrangements are affected by the legal system and market structure. In particular in civil law countries, trust law concepts such as fiduciary duty and prudent-person rule need to be embedded within the law, and even then the element of moral suasion inherent in trust law may need to be replicated in other ways such as closer supervision.
- Acting, and especially investing, in the best interests of participants can prove to be challenging for commercially owned funds where there is a competing profit motive.
- There is in any case a question as to how much fiduciary duty and prudent-person

principles can be enforced in practice, and hence the design of the market structure can be critical. They need strong and clear regulatory articulation (as indeed has proved necessary even in ‘trust law/ countries).

- The extent to which fiduciaries and investment professionals have the expertise to implement good practice investment governance, strategies, and process, or indeed suitable locally available financial instruments, can substantially constrain investment diversification, risk management, and returns.

In practice, much of the focus in implementing new pension systems in emerging economies has been on providing a governance and legal framework that ensures that pension assets are secure and well administered so as to build trust in circumstances where trust in reliability of financial institutions is far from assured. Hence, features such as specially instituted independent custodianship, fund sponsorship by large reputable corporations, and robust and detailed supervision are almost universal. Such understandable caution commonly extends to detailed regulatory limits on investment classes and instruments which embed risk aversion into investment governance.

APPLYING GOOD GOVERNANCE PRACTICES TO PENSION INCLUSION INITIATIVES

Some pension inclusion initiatives covered in this volume have used existing pension funds, with the benefit of enabling immediate scale benefits and leveraging already proven trust-worthiness. In such cases, however, care will be needed, going forward, to ensure that the interests of inherently small-scale investors are protected, in particular from high costs or limited investment returns. Several of the examples covered in this volume and elsewhere have, however, sought to develop or harness market structures in a way that is consistent with the lessons learned regarding pension fund governance.

The Mbao pension fund in Kenya provides an example of adopting existing structures. The administration of the fund has been entrusted to a trust-based (not-for-profit) pension fund established especially for the purpose, under existing pension law and within a long-standing, and hence trusted, framework of pension trusts. The trustee is a corporate trustee established by a Kenyan bank, which is also the custodian, and is totally separate from the out-sourced investment management function provided by a large local asset manager. The trustee has duties in trust and statute law to act in the interests of the beneficiaries. Being a fund specific for the initiative the trustee is not distracted by having also to focus on a pre-existing participant base. Obviously as a new fund, it has not started with scale benefits, but has sought to overcome this by out-sourcing to a large investment fund with substantial pension fund investment experience, which should therefore deliver scale benefits albeit requiring effective oversight by the trustee and managers of the pension fund. Whether the trustee has the ability or motivation to oversee effectively

the investment strategy implemented by the asset manager is an issue for the future, but Kenyan law is clear that the ultimate responsibility for investment is not delegated.

In India, governance arrangements for the National Pension System have been established so as to maximise scale with fiduciary oversight and un-bundling of functions for efficiency. The Pension Funds Regulation and Development Authority (PFRDA), the governmental regulator, and supervisor, has established and sponsors the National Pension System Trust to administer the fund, with record keeping out-sourced to the Central Record-keeping Agency.¹⁶ Investment is managed by pension fund asset managers contracted to and overseen by the trust, along with independent custodians. Five distinguished independent trustees are appointed for this purpose.

The arrangements are designed to keep costs low by unbundling of services that are allocated to appropriate specialists – and it has done this very successfully with PFRDA calculations of the long run equivalent asset under management cost being 0.18% a year. Unusually, the PFRDA remains responsible for guiding the overall strategic asset allocation of the funds, by means of regulation, leaving the asset managers responsible for more tactical aspects of asset selection, under the oversight of the NPS Trust, supported by the independent auditors that it appoints to monitor compliance with the strategy and regulations on costs. Hence, the Trust shares strategic oversight responsibilities with its sponsoring regulator. There is some reliance on competition between fund managers to secure good net returns, and it remains to be seen how effective this proves, and whether the large number of separate investment funds significantly dilutes scale benefits. The cost control has contributed clearly to the superior returns from the NPS pension funds compared to mutual fund providers of similar asset allocations. Furthermore, best practice would suggest that the Trust should assume the responsibility for letting out-sourced contracts currently allocated to the PFRDA.

Achieving the scale needed for strong investment governance and low costs is a particular challenge in smaller countries. This challenge has been addressed in Kosovo, a relatively poor country with a population of under 1.9 million, where after independence a new mandatory contributory (DC) pension system was established.¹⁷ The Kosovo Pensions Savings Trust was established from 2002 by the Assembly of Kosovo as a not-for-profit entity to administer the funds, with a governing board comprising expert trustees appointed from within and outside the country. The trustees are responsible for the investment strategy and appoint the board of directors, independent custodian, and professional fund managers to execute the investment strategy. Given the limited opportunities for local investment most of the fund has been invested globally. Because there is only one fund, and contributions are mandatory (albeit only from the formal sector) the fund has accumulated assets under management of some USD 1.4 billion,

¹⁶ A second record keeping agency has been licensed to increase competitive pressure on costs and fees – early indications are that it is achieving this objective.

¹⁷ Two separate voluntary funds have also been established for additional savings which are administered by the Slovenian-Kosovar Pension Fund, a more conventional commercially owned organization, which also benefits from the scale economies associated by being the single provider.

enabling some sophistication and diversification within the strategy. The trustees have implemented a clear long-term and diversified strategy that has generally performed well – problems have been caused by gaps in re-establishing the governing board at a change of mandate.

Pension inclusion initiatives are not confined to developing countries. The developed world is also struggling to cope with insufficient penetration of pension plans in voluntary pension systems. We have learnt from behavioural finance that financial decision-making is characterised by inertia and behavioural biases. Increasingly, initiatives are implemented to cope with these shortcomings – particularly if there has been a large role for individuals – which some countries have but many others do not.

The US experience has seen a shift from DB to DC and a number of shortcomings of individualised DC plans. The main problems have been seen in the low penetration, agency issues, and financial illiteracy. In response, employers are now legally allowed to auto-enrol all employees within the existing fiduciary governance structure. Addressing the agency problems, The Department of Labour issued a new fiduciary rule, the Regulation of Financial Advice, extending the circumstances under which investment managers, investment consultants, advisers, and intermediaries are treated as fiduciaries. And the investment industry developed target-date concepts that are implemented as the default option and shall ensure much better results for the gross of individuals who do not make a financial choice. Pension penetration has increased significantly (Choi 2015).

In the U.K., the National Employee Saving Trust (NEST) was also established by the government but one that works at an arms-length from it and is a trust-based (not-for-profit) pension fund. This operates as a master-trust within a well-established trust and pension law framework. The fund maintains a clear distinction between the strategic oversight role of the trustees and the managerial role of the executive. In view of the rapid expansion of membership and funds under management anticipated, and achieved, there may in the future be a change from the initial strategy that focused on largely passive out-sourced investment management under clearly defined asset class mandates. It also is able to focus its attention and strategy on the needs of its target market of relatively low paid participants with little or no prior experience of pensions. Its innovative approach to target date investment reflects this – in addition to volatility reduction towards retirement there is also low volatility investment for the youngest participants who, because of their minimal experience of pension funds or market investments, might be apprehensive of the system with regards to a capital loss in their fund.¹⁸

NEST's approach to investment governance transparently reflects the good practice outlined earlier in this chapter, coupled with a strong emphasis on communicating their approach to employers and participants. The board of trustees are responsible for the investment strategy, taking advice from the Chief Investment Officer, ensuring that he/she has sufficient expertise. The written advice considers the suitability of the investments;

¹⁸ While NEST's main competitors have not emulated this approach, which runs counter to much existing theory, this may well be because of differentiation in the markets targeted by the different funds.

the need for diversification; the suitability of NEST's fund managers; the investment risk management framework; and investment beliefs (principles). The trustees have an investment committee, supported by expert advisors, with clear delegated decision making responsibilities, who in turn appoint, monitor, and dismiss the professional asset managers responsible for day-to-day investment. NEST currently invests through investment funds provided by leading fund management companies. Each of these funds has a clear investment objective and generally invests in a single asset class. NEST diversifies its scheme members' money across different 13 different asset classes by investing in each of these funds in varying proportions. As assets under management grow, the expectation is that they will move into direct investments.

NEST's trustee board has set an overarching investment objective for the default funds "to target investment returns in excess of inflation after all charges over the long term". The investment policy statement explains how this objective is quantified in the different phases of saving. NEST's investment beliefs are subject to an evidence-based review at least every three years and are currently stated as:

1. Understanding scheme member characteristics, circumstances, and attitudes is essential to developing and maintaining an appropriate investment strategy.
2. As long-term investors, incorporating environmental, social, and governance (ESG) factors is integral to the investment management process.
3. Taking an investment risk is usually rewarded in the long term.
4. Diversification is the key tool for managing risk.
5. Risk-based asset allocation is the biggest driver of long-term performance.
6. Taking account of asset values and asset prices, economic conditions, and long-term market developments enhances long-term performance and informs strategic decisions.
7. Indexed management, where available, is often more efficient than active management.
8. Good governance, including an appropriately resourced in-house investment function, is in the best interests of NEST members.

Germany provides a further example. Following a significant pension reform in 2000/01, which reduced future benefits from the first pillar PAYGO pension and aimed at encouraging funded occupational pension provision, unions, and employer associations founded new pension funds. The largest is MetallRente, the pension fund for the metal and electrical industry with 580,000 members as of 2015. It was set up as a two-tier arrangement, with the institution itself led by a managing director overseen and controlled by the supervisory board. Its mission is to achieve the highest possible penetration of low-cost pension plans in the metal and electrical industry (and some associated industries) in Germany. Aligned with the traditional market structure and savings behaviour in Germany, MetallRente offers mostly insured products but, additionally, also a pension fund. An investment committee consisting of three representatives, of the employer

association and the union respectively plus one independent investment professional, sets the strategic asset allocation and the investment policy of the pension fund. The complete organisation is outsourced to four insurance companies and asset managers in Germany. MetallRente itself is not an institutional investor; its task is mainly to negotiate the plan design and to control, especially cost-control, the consortium. MetallRente has reached a high penetration based on its reputation and the trust generated by unions and employer associations.

Finally, all these pension inclusion initiatives, and indeed other examples in this volume, are subject to a framework of robust regulation and supervision, which should ensure the security of good administration of the assets and records. The main regulatory drivers for investment efficiency have related to market structure and requirements for fiduciary responsibility. Supervisory techniques to help ensure efficient outcomes are less well developed, beyond setting limits on fees and asset concentration, and supervising the propriety of fund management, which places the onus on fund governance to be diligent in implementing high performing strategies in accordance with best practice.

SUMMARY CONCLUSIONS

An essential underpin of any significant process of expanding pension inclusion is that the population new to this concept have good reason to trust the system and the entities concerned. This means that assets need to be held securely and invested efficiently at low cost, which in turn necessitates a suitable pension governance model. The ‘traditional’ DC model where participants are expected to choose funds or investment portfolios is not appropriate, and therefore, strong emphasis needs to be placed on an effective and expert fiduciary role, in a context where there are (usually) no sponsoring employers to represent participant interests.

Pension regulatory frameworks commonly provide strong asset security arrangements, especially in developing countries, but less attention may be given to investment efficiency and effectiveness. There is no shortage of literature on how the pension fiduciaries of large pension funds with ready access to liquid deep financial markets should organise investment governance, and there is research evidence that supports many of the prescriptions made. Applying these to many of the pension systems covered in this book is more challenging. But, some lessons appear to be applicable and have been reflected in some of the cases in this book. In particular:

- Scale is vital, not just because it lowers unit costs, but also it avoids spreading limited expertise too thinly and can enable more sophistication and diversification within the investment portfolio. This means restricted (or no) competition between fiduciary organisations, compensated for by a separation between the fiduciary entity and service providers, especially asset managers through which fiduciaries can impose some competitive discipline.

- There are strong arguments for improving the consequent structure if it becomes two-tier with fiduciaries being responsible for strategic oversight, executives for in-house elements of administration and for overseeing the asset managers and guiding the fund's investment strategy.
- Where practicable, not-for profit fiduciary boards should be established, maybe by regulatory governmental agencies, to ensure there is sufficient expertise while minimising agency risk.
- Cost and return transparency is essential – and not easy to achieve.
- The limited diversification, and hence scope for risk management, provided by the assets available to pension funds needs to be addressed, at least in the longer term once there is confidence in investment governance. On the other hand, investment governance can only be expected to mature once significant diversification is possible, and regulatory restrictions on asset classes may need to be relaxed.
- Regulatory and supervisory vigilance and pro-activity is needed to establish high standards.

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