

Managing public pension reserves: Lessons from international experience

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American Enterprise Institute

“Socially Responsible Investing and Pension Funds”

Washington D.C., June 7, 2004

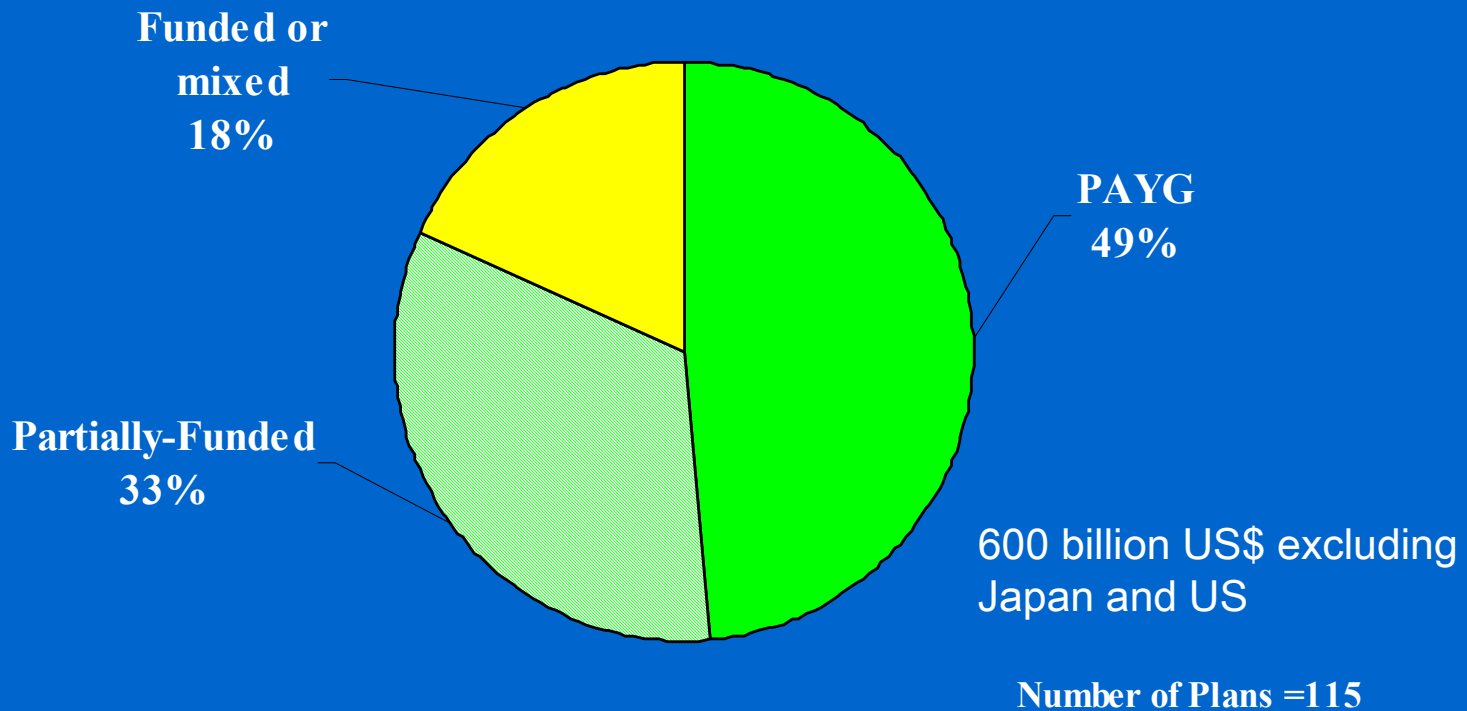
Structure

- Part I: Global prevalence of public pension funds; experience with governance, investment policy and performance
- Part II: Review of recent initiatives in five OECD countries
- Conclusions

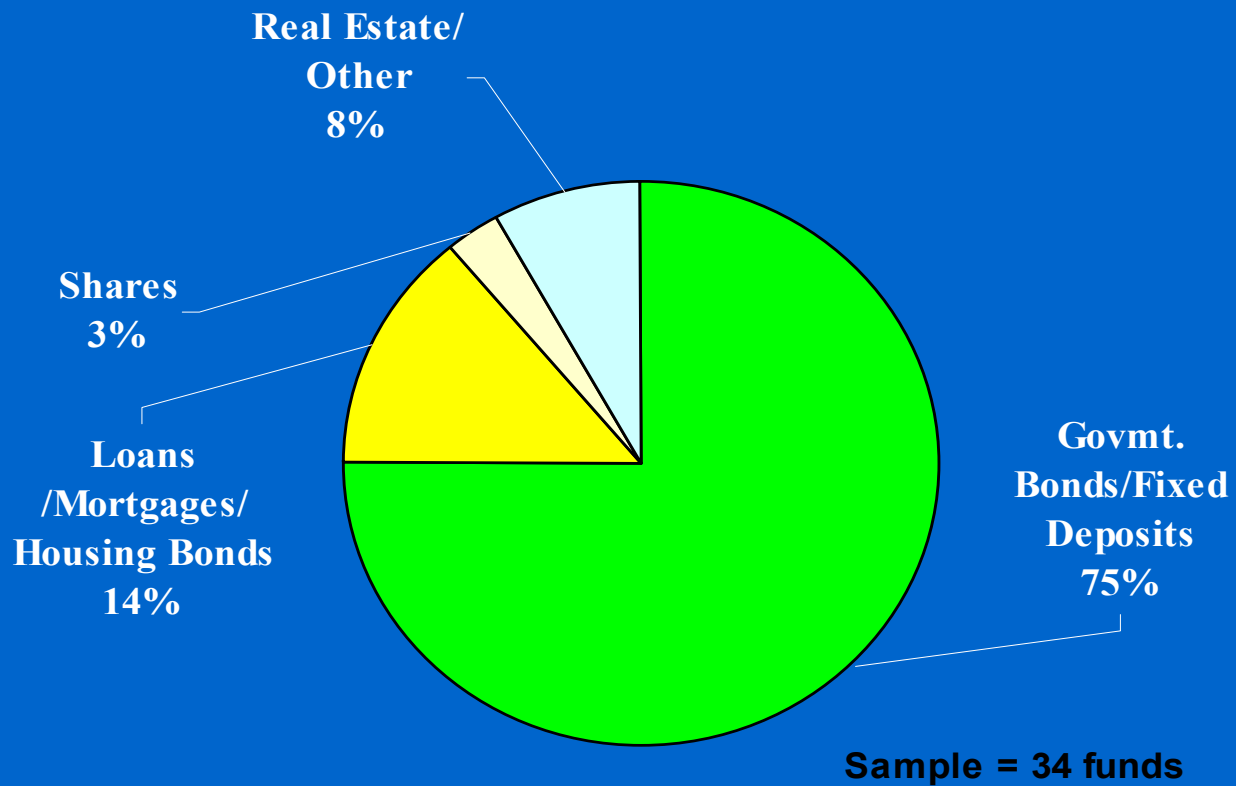
Part I

Global prevalence of public pension funds; experience with governance, investment policy and performance

Funding around the world

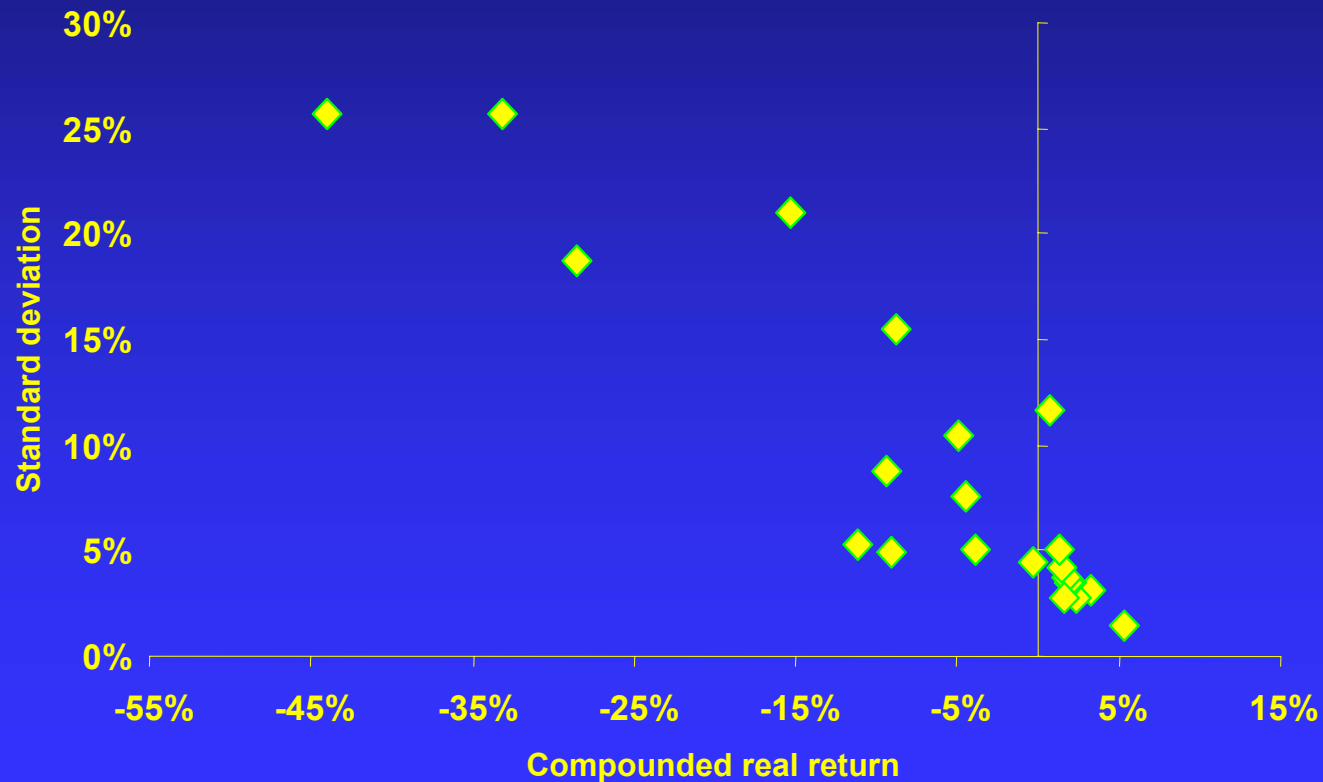


Observed portfolios



Investment policy and results

real returns and volatility,
22 publicly-managed funds, 10+ years



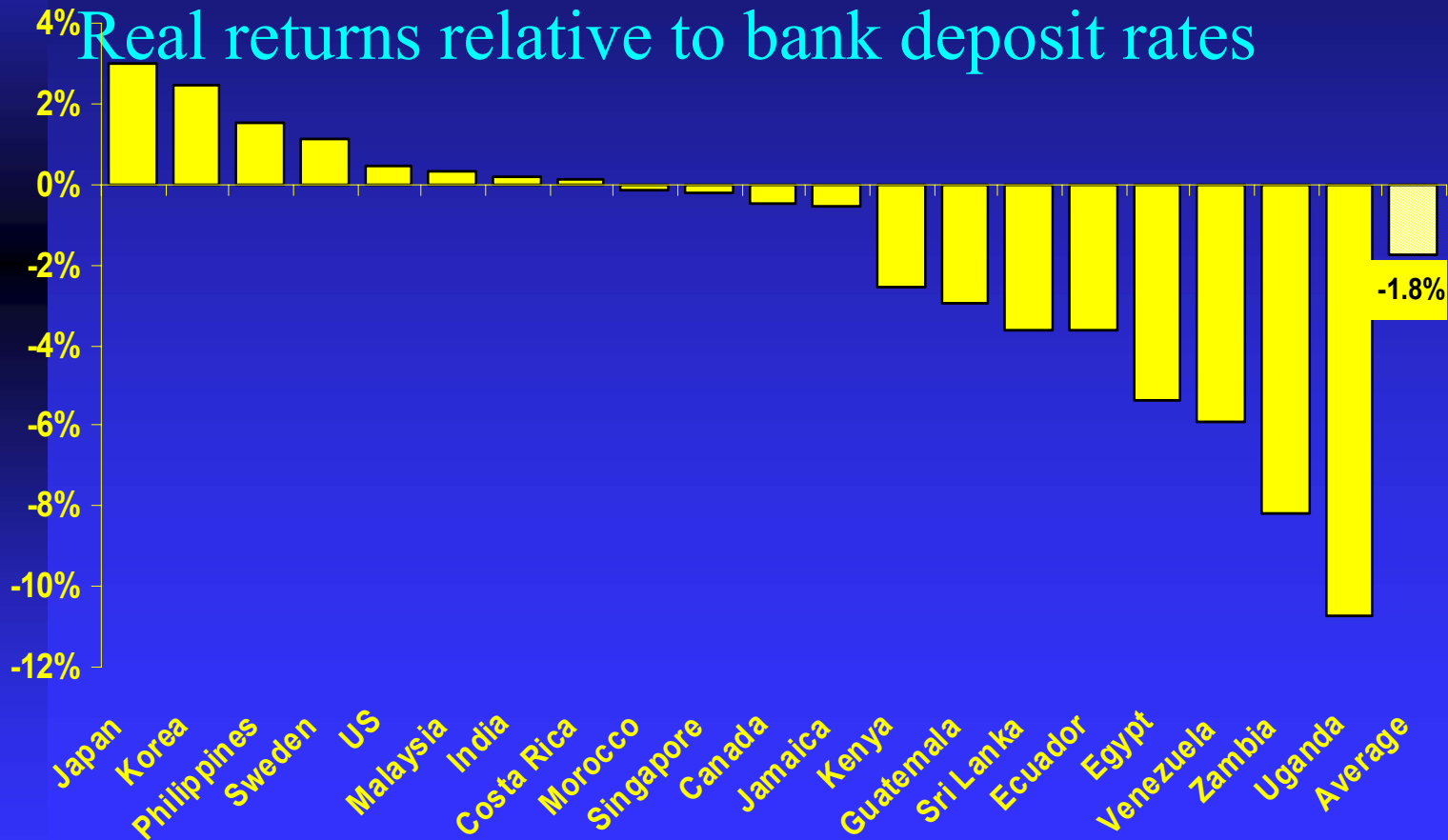
Governance structure

- Tripartite boards with executive control exerted through political appointments
- Monopoly in house public management
- Managers with little incentive to take risks and no competition
- Constrained by investment policies that do not provide mandate to act in the interest of beneficiaries

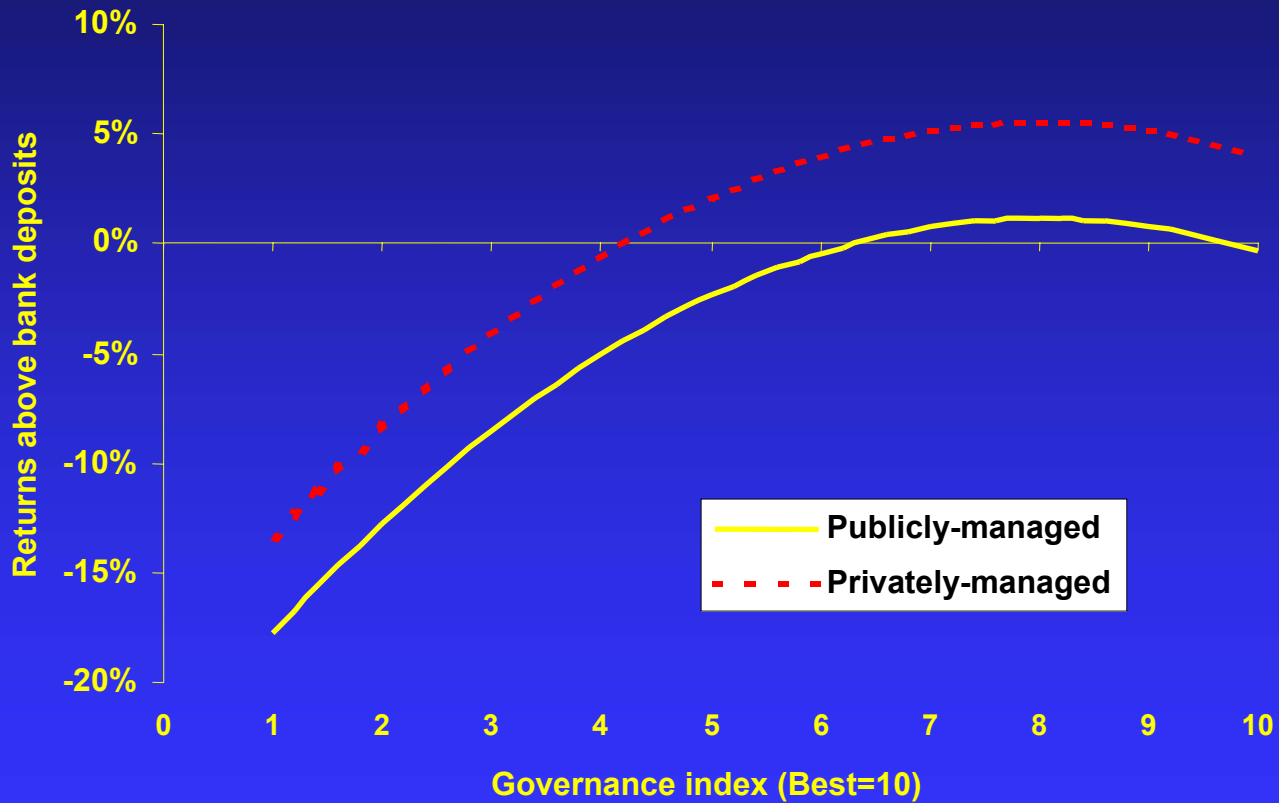
Restrictions and mandates

- Investment policies often include non-pension objectives
 - ◆ ‘social investments’
 - ◆ development projects
 - ◆ housing most popular
- Corruption in extreme cases
- Often used to finance national or subnational governments
- Mostly prohibit foreign investments

Investment policy and results



Governance and performance



Part II

Review of recent initiatives in five
OECD countries

Five OECD initiatives

- Canada (1998)
- Ireland (2000)
- Japan (2001)
- New Zealand (2001)
- Sweden (2001)

Initial conditions & policy debate

- Canada, Japan and Sweden had significant reserves with low returns
- Funds had been used for other public policy objectives – in Canada to finance provincial government, in Japan to finance second budget and ETIs and in Sweden to support mortgage lending
- New Zealand and Ireland have modest public schemes and never prefunded

Initial conditions & policy debate

- Final arrangements tempered by country specific circumstances
 - ◆ Canada and Japan include long transition periods to new asset mix
 - ◆ New Zealand's Greens forced ethical investment provision
 - ◆ Ireland was running large surpluses
- Each arrived at prefunding of public DB promise after debates that rejected private IA

Comparison of 5 initiatives (1)

- Board composition and selection
 - ◆ Canada, Ireland and New Zealand use professional boards; Canada and New Zealand use 2 step nominating process
 - ◆ Sweden retains tripartite model
 - ◆ Japan run by government Minister
- All require annual external audits
- All move to more external management
- All apply objective monitoring criteria and use of benchmarks

Comparison of 5 initiatives (2)

- Except Japan, all specify commercial investment mandate
- Portfolio limits:
 - ◆ New Zealand applies none
 - ◆ Ireland prohibits domestic public bonds
 - ◆ Sweden and Canada limit foreign
 - ◆ Japan most intrusive in practice
- Mandated investments limited to public bonds (Sweden and de facto in Japan)

Comparing the 5 initiatives (3)

	Canada	Ireland	Japan	New Zealand	Sweden
	<i>Degree of safeguards against each threat</i>				
Increased public borrowing	High	High	Low	High	Moderate
Social mandates/ETIs	High	High	Moderate	High	High
Capital market distortions	Moderate	High	Low	High	Moderate
Corporate governance conflict	moderate	High	Moderate	High	Moderate

Feasibility of central prefunding

	Canada	Ireland	Japan	New Zealand	Sweden
Stock market cap % of GDP	64	43	72	56	78
Value traded % of GDP	32	33	24	15	41
Foreign exchange restrictions	None	None	None	None	None
Accountability ranking (out of 173)	18	9	35	7	4

Feasibility of central prefunding

- Most countries with public reserves are characterized by:
 - ◆ small, illiquid capital markets
 - ◆ foreign exchange restrictions
 - ◆ small funds in absolute terms
 - ◆ poor governance (in broad sense)
- Empirical evidence reveals importance of last condition

Conclusions

- Historically, public pension funds have suffered from restrictions and mandates that led to the financing of deficits, ETIs and social investment
- The five OECD initiatives reviewed show that some risks can probably be mitigated:
 - ◆ Commercial investment mandates
 - ◆ Professional, arms' length boards
 - ◆ Allowing foreign investment
 - ◆ Reporting and disclosure
- Social investments were by and large rejected

Conclusions

■ But...

- ◆ Experience is very limited and there may be pressures in the future as funds grow
- ◆ Most countries don't have domestic capital markets allowing them to follow OECD 5 and have political constraints on investing abroad
- ◆ Governance still dominated by tripartite boards with penchant for SIs and ETIs
- ◆ Pressures are felt even in countries with privately managed, individual accounts
- ◆ But SIs less likely where effect on return is felt directly by member and choice exists