

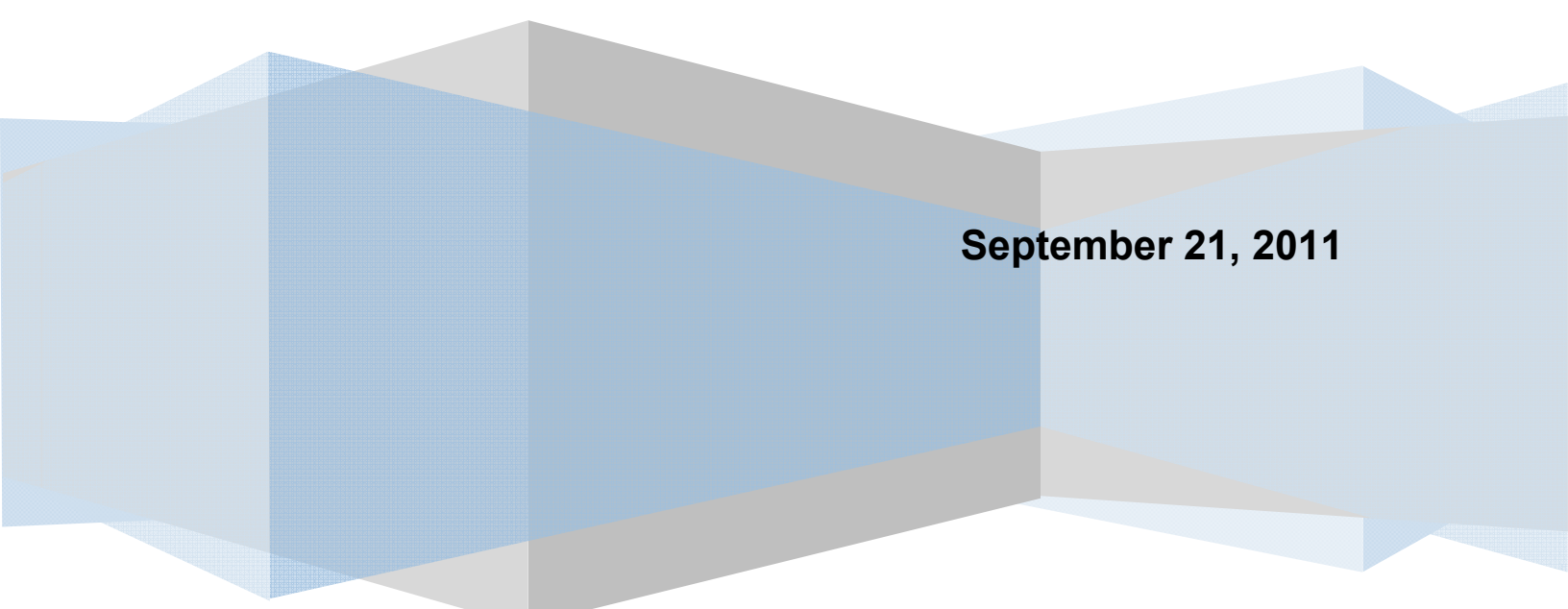
International Monetary Fund

# **Governance in the Funds and Investment Market**

**Presented by  
Dr. Gene Leon  
IMF Senior Resident Representative, Jamaica**

**KPMG Seminar: Achieving Regulatory Compliance &  
Administrative Efficiency within the Funds &  
Investment Market**

**September 21, 2011**



## **Greetings....**

My message this morning is that all challenges present opportunities.

How one manages those opportunities depends on best practice governance.

### **I. What is the role of the funds and investment sector?**

A country's financial system includes its banks, securities markets, pension funds, insurers, market infrastructures, central bank, and regulatory and supervisory authorities. These institutions and markets provide a framework for carrying out economic transactions and monetary policy, and help to efficiently channel savings into investment, thereby supporting economic growth.

As past crises have demonstrated, problems in financial systems can exacerbate economic downturns, and trigger capital flight or create large fiscal costs related to rescuing troubled financial institutions. Moreover, with increasing financial and trade links between countries, financial shocks in one jurisdiction can rapidly spill over across national borders.

Therefore, resilient and well-regulated financial systems are essential for both domestic and international economic and financial stability.

Service organizations, such as pension funds, play the very important role of intermediation and channeling of retirement savings. As such, they perform the role of linking households, financial institutions, the government, and to a limited extent the rest of the world, provided they are able to invest outside.

The sound management of assets to meet liabilities, asset/ liability matching, is an important, ongoing process for these organizations. Asset-Liability Management is defined by the Society of Actuaries (1998) as “the practice of managing a business so that decisions on assets and liabilities are coordinated.” This may sound simple, but involves a lot more than financial issues; it also involves good governance and necessitates the ability to monitor and assess assets and liabilities in a timely and reliable manner.

The success of these organizations is of high importance to clients and the broader economy. Because these institutions play such a significant role, there is need for appropriate safeguards, usually captured through

a regulatory regime. The regulation framework, by definition never totally comprehensive, must be evolutionary in nature, such that changing conditions can be incorporated to the benefit of all stakeholders.

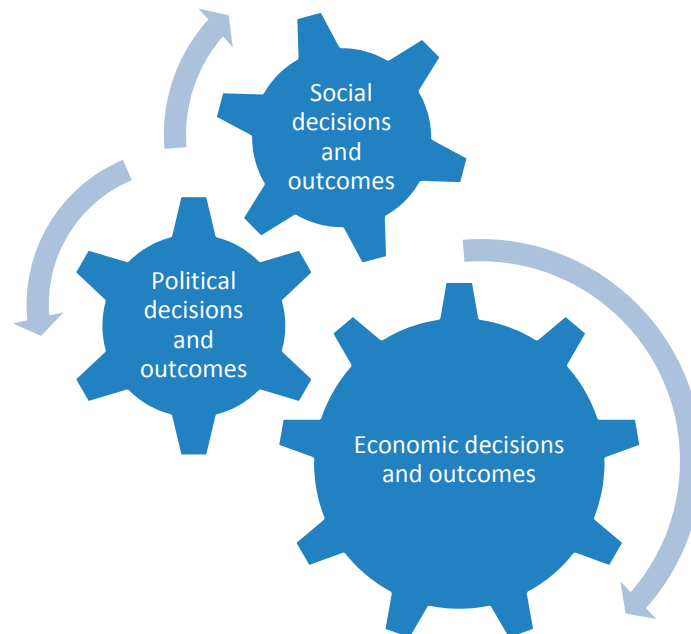
A regulatory framework is only as strong as its weakest link, whether that link is an institution with systemic importance or is an institution providing a key service to another institution. In that regard, third party assurance reporting constitutes an important link in the regulatory chain. It provides users with information about the internal controls in a service organization, the most widely well known of which is SAS 70. Increasing realization on the importance of effective controls has prompted the issuance of a new standard ISAE 3402 to replace SAS 70. Regulation ISAE 3402 specifies a new framework for assessing and reporting on the effectiveness of controls operating at a service organization, when those controls are likely to be part of the user entities financial information system.

The enhanced reporting has both short- and medium-term benefits for a corporations' administration, trustees, and business operations. One benefit is increased competitiveness through enhanced signaling, giving

comfort to clients that proper controls are in place. ISAE 3402 goes beyond the focus on financial reporting requirements, covering areas like operational and compliance controls as well as disaster recovery controls. Potential benefits also include generating in firm awareness of the importance of controls and providing comfort to management on the design and operation of controls. Importantly, adopting this standard will allow for better comparisons across institutions.

Indirectly, by providing “protection benefits” to user entities, the standard also contributes to protection of consumer clients and equity owners.

This is a reflection that in a modern economy all sectors are inextricably linked, with outcomes in one sector impacting on another.



## //. What is governance?

Governance is a broad concept covering all aspects of the way a corporation (even up to a country) is governed, including its financial policies and regulatory framework, as well as adherence to the rule of law. Dimensions to governance include adequate voice, stability, effectiveness, quality of oversight, adherence to rule of law. Governance covers:

- annual reviews of policies, carried out through audits, safeguarding the resources of equity holders or owners. Audits can be likened to good practices in fiscal transparency:
  - detailing relationships among affiliated corporations,
  - adherence to clear rules and regulations (internal oversight and control, independent external scrutiny, and national laws/regulations),
  - assessment of the accounting system, as well as solvency and financial health;

- public dissemination of timely, quality, clearly written, comprehensive information of past and current activity, and major financial risks/exceptions in the corporations' accounts.

Accountability is enhanced through internationally recognized standards and codes of conduct (e.g., ethical standards of behavior, financial disclosure requirements for senior staff, and a system of penalties for violations).

Good governance, which can be defined as all resources utilized in the investment decision-making process, is increasingly being seen as an important aspect of an efficient investment system. It is the key to success, with improvements in governance typically leading to a significant improvement in outcomes (income, profit). Empirical evidence links good governance among funds to:

- Enhanced performance and returns while maintaining stability;
- Greater control over the management of the plan;
- Potential decrease in administration costs.

Conversely, a poor governance environment offers greater incentives and more opportunities for abuse, threatening integrity, fairness, and trust. To the extent that these resulting inefficiencies have opportunity costs, they can be viewed as indirect penalties on equity.

### **III. Taking a broad view on governance**

To focus the discussion on the state of governance in the funds market, consider the public pension sector. Prior to the global financial crisis, strong performance of funds contributed to a high level of reserve accumulation, in the Caribbean. This of course is due in part to a significant portion of the region's population being below retirement age. With the financial crisis came a decline in contributions, based on lower real wage growth and a general exit by workers from formal employment to informal activities. The distress in the financial sector has affected fund managers in select cases, namely the collapse of the Trinidad-based conglomerate CL Financial as well as the downfall of the Stanford Financial Group. In Jamaica, pension funds were further impacted by the Jamaica Debt Exchange, and the resulting decline in interest revenue consequent on lower coupon rates.



Pension funds, not just in the Caribbean, but worldwide, are facing funding risk in the current environment of low interest rates, slow economic growth and more volatile markets. Notably, lower future rates of return mean that pension funds need to manage insurance of technical reserves ever more efficiently to meet future liabilities.

In the current environment there may be the temptation, even the necessity, to take on higher risk in an attempt to increase returns. This is a governance issue. Why? Because it must be understood that with higher risk comes added responsibility. In that regard, we must note that public pension governance is a complex area where structures and processes depend upon country and scheme characteristics.

Outside of the challenges brought on by the global crisis, the region's pension funds have faced a number of other challenges:

*Sustainability:* Continuing maturation and population aging in most Caribbean countries will increase system dependency rates and challenge sustainability. *Addressing that risk is a governance issue.*

*Diversification:* There are limited avenues to invest. Regulations in most territories limit foreign investment, while some public funds are limited in the amount they can invest in the stock market in any given month (e.g., \$10mn net per month in the case of NIF in Jamaica). In Jamaica, for example, the high demand for fixed income instruments and limited supply, following the JDX, meant that bonds are selling at high prices in the secondary market. Additionally, procedures for transfer of assets (such as real estate) can make diversification a difficult task. *Making appropriate economic decisions and enforcing accountability to address these is a governance issue.*

*Predictability of contribution and benefits:* There is substantial worker and retiree uncertainty and risk stemming from the absence of benefit indexation, as well as the absence of valorization of the wage base for determining benefits. The absence of these does not allow for adjustments to pension funds in the face of inflation and compromise consumption smoothing. *Mitigating these risks, which have broad macroeconomic implications, is a governance issue.*

*Portability of pension rights:* A strong Caricom regional agreement has been established and implemented to provide for the portability of pension rights between member states. However, additional measures are needed to facilitate labor mobility within the region and provide for the portability of pension rights under occupational schemes. *Managing long-term portability risks is a governance issue.*

#### **IV. What is the way forward?**

What is the future state of governance in the funds and investments market? Have we been viewing governance too narrowly in the region? From an optimization perspective, where agents (government, corporations, and households) seek to maximize some lifetime “benefit” and from the viewpoint of an economy as an ecosystem where all parts interact across geographical space and time, governance has to be addressed in a holistic manner. As such, governance narrowly defined is insufficient on its own: reform, therefore, must encompass governance, regulation, and sustainability.

## **Reform**

Continuing with pensions, reform of the regional pension fund landscape must address internal governance, regulation, and sustainability. The establishment of the Caribbean Association of Pension Supervisors (CAPS), which has a multi-jurisdictional reach in pension supervision, is a positive step towards reforming the industry.

### *What constitutes good internal governance?*

According to best practice, pension fund governance systems should be risk-based, varying according to the size and type of plan as well as with the extent of risks faced, including extent of weak governance structures, and the unreliability of systems and management processes.

At one level, internal governance relates to structure: what are the lines of authority, accountability, and responsibility? How is authority selected, monitored, and replaced? How are decisions made? Governance structures play a critical role in determining the investment objectives, strategies, and tools of fund managers. In managing the risks of the fund

the governing body should carry out such important functions as<sup>1</sup>:

- **Assessing of the performance of persons involved in the functioning of the fund.** This includes persons in operation as well as those in oversight and strategic decision making. Importantly this also includes outside service providers such as consultants, actuaries, and asset managers.
- **Conducting regular reviews of the compensation mechanism to ensure that incentives are aligned correctly.** Compensation should be designed to motivate the trustees to act in the best interest of beneficiaries, and importantly to focus on long-term sustainability of the fund as long as the fund is a going concern. In the case of investment managers, this may be accomplished by partially basing compensation on risk-adjusted returns (returns alone may encourage unnecessary risk-seeking).
- **Identifying, monitoring, and correcting conflicts of interest situations.** Conflicts of interest can be managed by appointing independent board members. In many countries, regulators (UK,

---

<sup>1</sup> OECD Guidelines for Pensions Fund Governance, June 2009

Australia) have been given the power to replace conflicted trustees.

- **Implementing adequate risk measurement and management systems.** The risk management system should look at the major risks to which the fund is exposed, whether investment or operational related (including regulatory compliance, or disaster recovery). The risk management strategy should be proactive, focusing on balancing short- and long-term considerations.
- **Assessment of compliance with local law,** which speaks for itself.

There is a growing body of research that shows a direct link between good governance and superior performance of [pension] funds. In fact, a recent study estimates that the good versus bad governance differential can account for 1-2 percent of additional return per annum.<sup>2</sup>

---

<sup>2</sup> Best Practice in Investment Governance for Pension Funds

## **Regulation**

Similar to developments for deposit-taking institutions, the current economic climate has seen a need for increased regulation and legislation in the Insurance and Pension Fund market. Reform of pension fund regulations to make them more counter-cyclical can engender long-term viability, stability, and security of member benefits. At the same time, these reforms help broaden the regulatory perimeter of the financial sector.

Governments and policy-makers can make funding regulations more counter-cyclical by implementing the following measures<sup>3</sup>:

- Avoid excessive reliance on current market values for purposes of determining contributions. Regulators should enable pension funds and plan sponsors to dampen the volatility of market prices when determining contributions;
- Set minimum funding levels or targets that are consistent with the goal of benefit security;

---

<sup>3</sup> The Impact of the Financial Crisis on Defined Benefit Plans and the need for Counter-Cyclical Funding Regulations, OECD, July 2010

- Allow appropriate levels of over-funding in good economic times via more flexible tax ceilings. One possibility that could be explored, is for maximum contribution or funding ceilings to span a multi-year period rather than be set on an annual basis to allow greater management of cash-flows;
- Limit contribution holidays and plan sponsor access to surplus. Regulators should consider restricting the extent to which plan sponsors can take contribution holidays, offer additional benefits, or withdraw a portion of pension fund surplus, for example, only allowing them when a certain level of funding above the minimum level is reached;
- Encourage stability of long-term contribution patterns via appropriate actuarial methods. Actuarial funding methods should be transparent. The actuarial funding methods that lead to smoother contribution patterns could be encouraged by regulators;
- Incorporate flexibility into funding rules to reflect the overall volatility of funding valuations. While the primary goal of a pension plan is to provide secure benefits to plan members, funding regulations should aim at avoiding undue pressure on plan



sponsors at times when their own profitability or even continuity is under pressure;

- Require timely disclosure of audited financial statements and individual statements on benefits, investment policies, and actuarial reviews.

## **Sustainability**

At its core, the pension fund sector functions as a financial intermediary. How efficiently does it perform that function? Separate from internal governance and external or internal (self) regulation, the industry has to promote long-term sustainability by generating adequate returns to meet liabilities; improving efficiency in product and service delivery; increasing capacity through enhanced training opportunities to stay abreast of a fast-paced and diversified financial landscape; promoting aggressive educational programs to actual and potential clients; and continuing research into innovation.

For public pensions, an improvement in sustainability may require changes to the contribution rate, the accrual rate, or the minimum retirement age. Reform in these three criteria should be done by each

country under the watchful eye of [Caribbean Association of Pension Supervisors] [CAPS] to ensure a harmonious correction across jurisdictions.

**Building credibility and expertise:** Although limited by size, increased training in actuarial and investment-related skills, forging partnerships in research on valuation methods and risk management, as well as the development of standards, and the promotion of sound professional advice as well as an awareness of the role of pensions to society can all help in building a strong sustainable sector.

## **V. How do we go about implementing reform?**

We need to consider two elements:

- The process of transition: this involves managing change, IT processes, and communications.
- Determining the pace and sequence of implementation as well as the balancing of costs and benefits of the transition.

In getting past “the status quo”), the following considerations may be helpful:

- Governance does not have to take a generation to improve, but it should be well thought out and implemented without delay. Make improved governance part of your mission statement, create a road map with priorities and timed milestones, and pursue it resolutely.
- Consider People, Process, and Technology – IT fixes may not necessarily reduce or eliminate entrenched behavioral “norms.” Effective communication of vision, rationale, and process is key to getting buy-in from various stakeholders.
- Create an incentive-promoting environment: reward performance, including through recognition, and increase awareness and conformity with conflict of interest regulations.
- Take a holistic approach – integrate decision-making and leverage synergies across the corporation to scale up results.
- Transparency improves governance: public disclosure and timely dissemination instills discipline.

Standards setting is either reactionary, to problems that arise, or anticipatory, to counter potential problems. That responsibility should not only reside with a regulator. Just like the common thrust to manage the environment, in the interest of the planet, corporations should endeavor to continually enhance governance, even beyond best acceptable international practices. So having implemented the required standards, we need to recognize the fluidity of the evolving financial and economic landscape and stand ready to make further adjustments

## **Conclusion**

The investment strategies of service organizations are relevant not only from the perspective of returns [retirement income for pension sector], but also because of their impact on the development of capital markets and the supply of capital for innovative enterprises. There is in essence a symbiotic relationship between [pension] fund investment and capital market development.

On a less dramatic scale, but equally relevant from the perspective of beneficiaries, is the extent to which external quantitative restrictions on

asset allocation limit the degree of diversification of investment portfolios into riskier assets and hence hamper [pension] fund performance. Not only do these restrictions limit potential return, but in some cases make the asset portfolios more risky because of the lack of diversification. To encourage further diversification, intra-Caribbean and external investment limits should be increased within reasonable bounds.

In practice, good governance has been shown to go beyond minimizing potential conflicts of interest to delivering better performance net of costs. An additional benefit of proper governance by institutions is it acts as self regulation, reducing the need for more intrusive regulation, sparing the funds the impact of costs associated with additional regulation.

Improved governance and reform of pension fund regulations are key to long-term sustainability of the industry and broad financial sector.

Improving governance is by no means an easy task for [pension] funds or their regulators; however the business of pensions is too important to the security of a nation for it not to be a priority. And striking an appropriate balance between enhanced regulatory norms and promoting

innovation and competition is a challenge. While legislation and regulation are important, let's not forget the role of ethics, training, and leadership for the managers and staff of the industry.

At this juncture, [pension] funds have an opportunity to be an active intermediary in the financing of growth, and in aiding the development of the capital market in the region. Let the reforms happen and reshape the impact of [pension] funds on the region.