

PENSION FUNDS FOR GOVERNMENT WORKERS IN OECD COUNTRIES*

Introduction

In the past few years, there has been a trend towards the harmonisation of pension policies for private and public sector workers, with the introduction of some pre-funding or fully funded complementary pension schemes. This process has been driven mainly by the necessity to alleviate the fiscal burden imposed by relatively generous public employees' pension schemes, enhance labour mobility and build more equitable and financially sustainable social security systems.

In many OECD countries civil servants' pension funds are among the largest in terms of assets and number of participants and constitute an important share of financial assets. In 2003, 7 out of the top 10 worldwide largest pension funds in terms of assets were occupational schemes for civil servants.¹ The significance of the government workers pension funds is explained by the fact that governments are often the largest single employer at national or local level (and thus preside over larger funds). Additionally, civil servants' employment is more stable and sponsorship is established on long-term basis. In contrast with the private sector, governments have more instruments at their disposal to address potential solvency problems and ensure the financial stability of a pension fund.

Generally, though government workers' pension funds are locally regulated and supervised, they are often global players. International and national financial markets are sometimes strongly influenced by their institutional investment decisions, taken according to their specific, although not always very well understood, governance structures. Moreover, their relatively large size implies substantial and broad interactions with banks, insurance companies and mortgage and credit markets. In some cases (*e.g.* the Netherlands), government pension funds control subsidiaries and affiliated companies operating as financial conglomerates. They also have huge investments in corporations and hold the management control or participate in the management boards of these companies.

These funds are exposed to particular risks related to the multiple roles played by the state in the regulatory, supervisory and operational fields. The state is, at same time, sponsor, regulator, supervisor, service provider, fiduciary agent and recipient of pension fund investments. Specific government-related agency problems can arise with respect to these funds which differ from those frequently analysed in the private sector. Given the state's responsibilities as plan sponsor, fiscal accounts are also quite vulnerable to their performance and results and eventual funding or investment problems in some of the largest pension funds might provoke financial and fiscal turmoil. Frequently, taxpayers are invited to share the sponsor's responsibilities through increases in taxes, issuance of public debt or reduction in public expenditures in other areas, from which resources are reallocated to finance eventual unfunded liabilities.

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This paper reviews the experience of the government employees' pension funds of Australia, Canada, Japan, the Netherlands and the United States. The report covers six pension funds – the Public Sector Superannuation Scheme (PSS) of Australia; the Ontario Municipal Employees Retirement System (OMERS) from Canada; the Federation of National Public Service Personnel Mutual Aid Associations (FNPSMAA) and the Pension Fund Association for Local Government Officials (PFALGO) from Japan; the Pension Fund for Civil Servants of the Dutch Government (ABP) and the California Public Employees' Retirement System (CalPERS).

The document was prepared based on the replies of these pension funds to a questionnaire elaborated by the OECD Secretariat. Additional information was collected from their annual reports and other statements disclosed in their websites.

The following section introduces the discussion on pension reform in civil servants schemes showing the trend towards to pre-funding and to convergence between public and private workers' regimes. The third section addresses the main risks related to the presence of the government as plan sponsor. The fourth section presents case studies focusing on their institutional framework, governance, investment and funding practices. The last section identifies some good practices experienced in the case studies on how to avoid or mitigate the risks inherent to civil servants' pension funds.

Pension Reform Trends in the Civil Service

In most countries, government workers were the first category covered by social security schemes. Some European pre-Bismarck pension schemes for civil servants, which were mostly based on earnings-related arrangements, date back to the beginning of the 19th century and were created as a reward for the length of service dedicated to the state.

Throughout the 20th century, despite the gradual broadening of social insurance policies and the development of national pension schemes, separate and comparatively more generous sub-systems were maintained for civil servants in several countries. The degree of separation and generosity is currently explained by special labour conditions prevailing in public sector employment. Traditionally, the human resources management policies governing civil servants have been designed to stimulate longer careers and loyalty. Salaries have rarely been linked to productivity, as is the case (in theory at least) in the private sector. Generally, compensation has tended to increase gradually on a scale basis according to years of service, merit-related mechanisms and budget constraints. In this context, the relatively more generous retirement scheme has been expected to function as an incentive to employment in the public sector.

Nevertheless, in the past few years, there has been a trend towards unification and coordination of rules for both private and public sector workers schemes, with the introduction of some pre-funding or fully funded complementary pension arrangements. This process has been driven mainly by the necessity to alleviate the fiscal burden imposed by relatively generous public employees' pension schemes and to build more equitable and financially sustainable social protection networks.

A sample of selected countries is classified in four groups, according to the degree of institutional integration of the civil servants pension schemes into the general basic and complementary pension systems (Table 1).

Table 1: Civil Servants Pension Schemes in the Selected Countries

GROUP 1 Separated unfunded scheme	GROUP 2 Separated funded or partially funded scheme	GROUP 3 General national basic scheme + specific complementary occupational pension fund	GROUP 4 General national basic scheme + general complementary pension fund
Argentina (some provinces) China Colombia Brazil Belgium France Germany Greece Ireland Luxemburg Mexico Portugal Peru Turkey	Korea India Hong Kong, China Indonesia Jordan Malaysia Philippines Spain Singapore Thailand Chinese Taipei United States (some states' schemes)	Australia Austria Canada Costa Rica Denmark Finland Iceland Italy Japan Netherlands Norway Sweden Switzerland United States (Federal Workers and some states' schemes) United Kingdom	Argentina (federal and some provinces) Chile Czech Republic Hungary Poland Uruguay

Source: OECD

The first group includes countries with a completely separate earnings-based PAYG scheme for civil servants. Generally, the systems are comparatively generous for those servants, but initiatives are being undertaken to homogenise rules and provide incentives for private retirement savings. For example, France approved in July 2003 a reform intended to change the retirement age and benefit calculations in order to introduce more flexibility, discourage early retirement and harmonise public and private sector rules. Simultaneously, this reform established a new private pension savings plan based either on individual or collective affiliation to personal or occupational pension funds with tax exempt contributions mechanisms.

Mexico, back in 1997, introduced a radical reform of its general regime, replacing the PAYG system with a fully funded scheme managed by the private pension funds' administrators called *Administradoras de Fondos de Retiros* (AFORES). However, civil servants were not included in the reform, and have retained a quite generous regime without a retirement age limit, with high replacement rates and health care provision, carried out at the federal level, by the *Instituto de Seguridad Social y Salud de los Trabajadores del Estado - ISSSTE*. At the state level, there are several other pension schemes for state workers and universities, most of which are facing financial problems. The overall system presents two serious drawbacks: first, the existing rules tend to reduce transparency and produce cross-subsidies among workers; and second, the operation of numerous institutions reduces economies of scale and scope, thereby increasing administrative costs and inefficiency. Moreover, there is no portability or vesting between the different public schemes or between public and private sector schemes.

Mexican authorities are studying the homogenisation of rules and the replacement of the public PAYG with a fully funded personal mandatory scheme. The main discussion is related to the financing of the transition costs and whether the civil servants will join the new AFORES or maintain a separate occupation scheme operated by ISSSTE, which could reduce administrative costs and political resistance.

The Irish government approved, in 1999, a pre-funding strategy for civil servants, creating the Public Service Pension Fund. According to the new arrangement, a portion of the national public accounts surplus (almost 1 per cent of the GDP) is to be deposited annually in this fund for a period of 55 years.

In Brazil, a pension reform for civil servants was also approved in 2003. The government has implemented a comprehensive adjustment in the current PAYG system (retirees' contribution, retirement age increase, replacement rates reduction and benefits cap) with the introduction of complementary funded pension schemes. For future workers, the civil servants pension scheme will be quite similar to the private workers' system.

In the second group, Korea, Spain and some US states maintain fully funded or partially funded separate schemes for civil servants. In the United States, the employees' pension funds of the states of California, Florida, New Jersey, Georgia, Wisconsin and the New York City are among the largest in the world. Most of them are defined benefit plans and are not subjected to federal regulations regarding governance, investments and funding. A recent survey indicates that 25 per cent of all US public employees are not covered by the national scheme and, thus, their specific regimes provide basic and complementary benefits.² In Spain, there is a traditional complementary scheme called "*mutualidades*". These schemes are treated as life insurance companies and are subject to local regulation and are supervised by regional bodies. In the Basque Country and Catalonia most public sector workers are affiliated with one of these schemes.

In India, the Employees' Provident Fund is the world's largest pension fund in terms of number of participants, covering over 20 million civil servants. Recent reforms introduced a portable DC scheme for new entrants, with government contribution matching the employees' contribution. The new system was expected to start operating at the beginning of 2004.

In the third group, civil servants participate in a general basic scheme and have specific complementary pension plans. In Canada, most government workers contribute to the basic retirement fund (Canadian Pension Plan or Quebec Pension Plan) and have complementary specific funded regimes. Actually, in Canada, 8 of the top 10 largest pension funds are for government workers and 95 per cent of the total membership is in defined benefit plans.³

In Italy, officials recruited from 1995 onwards benefit from a pension system based on notional defined contribution arrangements equivalent to those of private sector employees. Austria approved, in November 2004, a pension insurance harmonisation law for civil servants and private sector workers. Additional tasks remain regarding the need to also include pensions of civil servants at the subnational level in the unified system.

Similarly, in the mid-80's, the US government introduced a new pension system for federal government workers that entered into public service after the reform. Post-1984 entrants are covered by the general scheme (Old-Age, Survivor and Disability Insurance – OASDI) and, in addition, by a defined benefit scheme and a defined contribution plan. This reform was adopted by some states that also integrated the basic component of their schemes into the OASDI and develop complementary regimes.

In Japan, civil servants are also integrated in the basic partially funded PAYG scheme (step-up contribution system) and, complementarily, contribute to the National Public Service Mutual Association. In Australia and the UK, workers receive the basic pension from the general system, but there are different rules for the complementary scheme. While Australian private workers are covered exclusively by defined contribution plans, the Australian Commonwealth Government Retirement Scheme and some State's schemes (*e.g.* New South Wales) adopt hybrid arrangements.

Denmark, the Netherlands and Finland have segmented funds for civil servants, but the rules are the same as for private sector funds. In the 1950s the Danish civil servants moved from a non-contributory employer sponsored defined benefit arrangement to a defined contribution scheme based on collective agreements. By contrast, the Dutch government workers scheme is managed by a unified pension fund that covers central provincial and municipal employees, police and the judiciary, defence, water, school, cultural and other public agency workers.

The fourth group includes countries that undertook structural pension reforms during the 80's and 90's, introducing mandatory private personal funded arrangements for the entire working population. In Latin America, the Chilean pension reform unified 32 different social security institutions and over 100 pension programmes with distinct contribution rates, benefit formulas, eligibility conditions and pension readjustment criteria. Colombia, Mexico and Peru introduced mandatory fully funded pension schemes, but only for private sector workers. Public servants are still covered by a more generous regime. Argentina's pension reform has not affected some provinces that were not integrated into the new system. In Eastern European Countries, such as the Czech Republic, Hungary and Poland, the pension systems for civil servants and for private workers were completely merged with both the basic PAYG component and the second mandatory funded pillar.

The pension reform experiences of the last decade have shown a gradual moving from the groups 1 and 2 to 3 and 4, with convergence of rules for public and private sector workers and introducing of funded components. Nonetheless, the pension funds for civil servants are exposed to specific risks explained in the next section that should be addressed by a proper regulatory framework.

Civil Servants' Pension Funds Risks

The key analytical difference between civil servants pension funds and the corporate private pension funds is the presence of the government (and hence taxpayers) as plan sponsor, which has important implications for the governance structure, investments practices, funding rules and disclosure policies to stakeholders. The main specific risks are related to the potential conflicts between the multiple roles of the state in the system, *i.e.* regulator, supervisor, sponsor, service provider, fiduciary agent and recipient of pension fund investments.

Civil servants' pension funds are more vulnerable to investment mismanagement risks. They are often required to, directly or indirectly, finance infrastructure, social projects or allocate resources on investments not necessarily linked to retirement income objectives. In some countries, like India, a minimum of 80 per cent of the Employees' Provident Fund assets must be invested in public bonds, which are, in some cases, non tradable. In other cases, they have more restrictive asset allocation regulations. Some investment boards are subjected to maximum limits or can only buy equities above certain rating classification, which constrains their investment strategies and reduces their capacity to optimise portfolio allocation, maximising returns and minimising risks.

There have been a number of cases in which pension funds have been mandated to make economically-targeted investments according to the government's political priorities. In Korea and Japan, government workers' funds have been oriented to finance hospitals, housing and infrastructure and welfare projects. Throughout the 1960s and 1970s, the Swedish government used pension fund reserves to expand housing opportunities.⁴ Some empirical evidence for the US shows that public pension funds that had been required to make a certain portion of in-state investments generated lower investment returns compared with other funds.⁵ In the case of defined benefit plans, popular measures such as extending personal loans for housing, education, health provision, or subsidies to mortgage markets can bring short-term relief to participants, but may generate future liabilities to taxpayers.

Furthermore, governments, as suppliers of financial products, can influence the pension funds' investment policies to achieve specific capital market and financial goals linked either to its borrowing constraints or to the valorisation of state-owned companies' equities.

Some countries are exposed to supervision ineffectiveness risks related to the lack of supervisory agencies' enforcement capacity to sanction the sponsor's irregularities and assure compliance with regulations. Generally, the recurrent unsanctioned irregularities are: (i) sponsors' contributions evasion, (ii) non-remittance or misappropriation of participants' contributions, (iii) the misuse of pension fund reserves, (iv) debt relief for sponsors; and (v) trustees' misbehaviour. The countries in which the supervisory agencies are not politically and institutionally independent might be more exposed to these risks. In some cases, the non-remittance of participant's contributions or the sponsor's evasion occurs due to fiscal restrictions and pension supervisors are under political constraints to apply penalties to high level authorities. The accumulation of non-paid or non-remitted contributions generates enormous sponsor's debts and, sometimes, these debts are treated as intra-governmental transactions and renegotiated on a non-market basis.

Additionally, there are principal-agent problems related to potential conflicting interests of the government and taxpayers in the management of defined benefit plans. Taxpayers eventually bear the burden of unfunded liabilities generated by mismanagement or underperformance that might arise from an increase in the employer's contributions or reallocation of fiscal resources. Besides the traditional principal-agent problems related to self-interest, self-dealing and corruption, there are additional risks associated with the political manipulation of investments.⁶ In this context, the governance structure should be designed both to avoid future transfers of liabilities to taxpayers and to prevent the use of the fund resources for politically targeted objectives that could reduce long-run returns.

Furthermore, in some cases there are administrative risks conditioned by the legal status of public pension funds. Generally, public agencies have limitations to select and monitor service providers. Human resources and salary scales used in the public sector may reduce the potential pool of qualified candidates for positions that are often highly remunerated in the private sector.⁷

Regarding funding risks, in contrast to arrangements in private workers' funds where the main funding parameters are contracted between the parties concerned, in the case of government workers' schemes, they are generally established and modified by law or, in extreme situations, by constitutional amendments. When the pension plan's entitlements, such as benefit formulae, contributions, actuarial and accounting standards, are set by law, the ability of the policy makers (or trustees) to adjust the plans according to the funding requirements may be constrained by political forces.

The legislative process can also generate mismanagement or unfunded liabilities, as some groups may promote changes that are not necessarily financially and actuarially sustainable. In the political arena, the collective action might benefit well-organised minorities at the expenses of the non-organised majority of taxpayers. This process is reinforced by the lack of transparency and limited financial education.

In the private sector, any unfunded liabilities are part of the sponsor's balance sheet, whereas in the case of governments' pension funds in some countries, they are rarely measured because the available records are not sufficiently reliable. Even when measured, they do not appear in the public sector accounts as a contingent liability.

The specific risks of civil servants pension funds introduce several challenges for regulators, administrators and stakeholders. The next section analyses some concrete experiences on how to deal with these risks.

OECD Experiences with Civil Servants' Pension Funds

The group of surveyed institutions is heterogeneous and comprehensive. In this sample, there are national (PSS, ABP) and local government pension funds (CalPERS, OMERS and Japanese Local Government Pension Fund). The amount of accumulated assets ranges from USD 180 billion (ABP) to USD3 billion (PSS). Membership varies from 309 thousand (OMERS) to 5.3 million participants (Japanese Local Government Pension Fund) (Table 2). The sample also contains relatively young schemes, as the PSS, that started to operate in 1990, and older institutions, such as, for example, the ABP, which was created in 1922.

Table 2: Pension funds for civil servants in selected OECD countries at a glance – 2003

	PSS	OMERS	ABP	FNPSPMAA (*)	PFALGO (*)	CALPERS
Categories covered	Australian Civil Servants	Civil Servants of Ontario's Municipalities	Employers and employees in service of the Dutch government	Japanese central government civil servants	Japanese local government civil servants	California Public Employees' Retirement System
Membership (thousand)	229	342	1,750	2,965	5,290	1,419
Contributors	220	249	1,074	2,069	3,181	1,002
Beneficiaries	9	93	676	906	2,109	417
Assets (USD billion)	3.1	25.6	180.2	78.0	113.1	165.3

(*) 2002

(**) Including deferred members.

Source: Replies to the OECD Questionnaire on Civil Servants' Pension Funds.

Institutional framework

Despite their diversity, the selected pension funds present several features in common. Generally, the pension funds for government workers are organised as public bodies with institutional independence and separated accounts and assets. The Australian PSS fund is managed by a board of trustees – the PSS board, a legal corporate entity established under public law and the fund's accounts are segregated. In Canada, OMERS is a statutory corporation established under specific legislation as an independent legal entity linked to the Ministry of Municipal Affairs. The Japanese civil servants pension plans are run by public bodies linked to and regulated by the Ministry of Finance (central government workers) and the Ministry of Interior (local government workers) and both institutions are separated with respect to the government administrative structure. The Dutch ABP is a non-profit organisation established as a foundation. It is an independent legal entity, created under private law, but ruled by public regulations. CalPERS is also a public agency established by state legislation and managed by an independent board of administrators with elected, appointed and *ex-officio* members.

All of them are entities functioning as multi-sponsored pension funds covering all the civil servants in the respective jurisdiction. Affiliation to the pension funds is mandatory for full-time government workers listed in specific legislations. In Australia, the PSS covers all public service employees and persons permanently appointed to positions with any Commonwealth public sector employer. The Dutch ABP is co-sponsored by 5.3 thousand employers in the public sector, including employees of central and municipal governments, police and judiciary, armed forces, water boards, utilities' agencies, school boards; culture and science agencies. In the same way, the affiliation to OMERS is a condition of employment for all Ontario municipalities and local boards. Currently there are approximately 670 employers registered in the pension fund. In the Japanese central government, there are 21 mutual aid associations (one for each Ministry) that delegate the responsibility for pension provisions to the Federation National Public Service

Personnel Mutual Aid Associations. The multi-sponsored model is also recurrent in the United States. CalPERS covers several jurisdictions as service provider and investment manager with participation of over 2.5 thousand public employers including the institutions of the State of California, schools and local public agencies.

Except for the Japanese pension funds and CalPERS, the other institutions were established with the sole purpose of paying retirement benefits. In Japan both central and local pension institutions also provide health insurance, recreational service and other benefits to employees and these services can also be provided to private sector workers. CalPERS also offers comprehensive health and long term care programmes for State employees by law and for local public agencies and school employers that can contract these benefits to their employees whether or not they contract for the retirement programme.

In the Netherlands, identical private pension regulations are applied to public and private sector workers. In Australia, Canada (Ontario) and Japan the regulatory framework is relatively similar for both categories, with insignificant differences. In Australia, there are some differences in the application of the prudential framework principles. Some unfunded defined benefit schemes are not required to follow the rules of the general legislation. However, they are generally subject to an agreement between the Heads of State Governments that establish principles for operating the funds, complying with the “spirit” of the legislative framework. In Japan, there are different legislations for public and private workers’ pension regimes. The former falls under the responsibility of the Ministry of Finance, while the latter is linked to the Ministry of Health and Welfare. The local government officials’ pension system is regulated by the Ministry of Interior, and the system for private schools by the Ministry of Education. There are separate laws for central and local government employees. However, the design of the system is very similar. In the US, CalPERS and other State employees’ funds do not need to comply with national provisions, except for tax qualification rules.

Characteristics of the pension plan

All surveyed institutions offer mandatory defined benefit (DB) plans. The Dutch ABP and CalPERS have a small defined contribution (DC) voluntary additional component. ABP offers a standard DC plan without either investment choice or any minimum guarantee. In Australia, the Government has announced a proposal to introduce a new fully funded arrangement for new employees with effect from July 2005. Under this proposal, there would be neither benefit nor return guarantees and members would have investment choice. The proposal includes a default investment strategy and the trustees would continue to determine the range of fund managers employed to undertake the investments. CalPERS offers a defined contribution supplementary plan restricted to state peace officers and fire-fighters and a 401k-style pension scheme.

In the United States, the federal workers are under a DC scheme, the Federal Thrift Savings Plan (TSP), and some states as Colorado, Michigan and Washington have also introduced either DC or hybrid pension plans for their employees. Anecdotal evidence suggests there are also legislative proposals under consideration in Florida, Georgia, Ohio, South Carolina, Tennessee and Texas.⁸ While in the other cases there is only one plan for all members, CalPERS offers five different and segregated defined benefit plans. Besides the Public Employees’ Retirement Fund (PERF), which represents around 80 per cent of the total membership, there are specific plans for legislators, judges, state peace officers and fire-fighters.

In the surveyed cases, benefits are paid in annuities or lump sum by PSS, OMERS, ABP and CalPERS. In Japan, there are only annuities, but lump sums are offered by different institutions. Generally, benefits are paid directly by the fund. In Australia lump sum benefits can be totally or partly converted into a non-commutable indexed lifetime pension that is paid by the scheme. However, the pension conversion rates and the government’s less favourable taxation treatment of lump sums encourage members to opt for

an income stream for at least half of accrued amount. OMERS provide portability options to members before early retirement. Upon direction from the member, institutions with registered “locked-in” savings vehicles can accept these funds (banks, insurance companies, etc.). Insurance companies can receive the funds to purchase a deferred annuity.

Table 3 presents the contribution rates in the surveyed pension funds. While OMERS and the Japanese funds adopt the matching employer/employee contribution rule, the Dutch employers sponsor 75 per cent of the fund’s actuarial requirements. The Australian system is more flexible and depends on the employee choice and on the evolution of the retirement profile.

Table 3: Contributions for government workers pension plans in selected OECD countries- 2003

	PSS	OMERS	ABP	FNPS PMAA (*)	PFALGO (*)	CALPERS
Employer	15.4% (notional)	Match employee contribution	17.2 5%	7.19%	6.48%	State misc. 13.2% - 17% State Industrial: 16.4% Safety: 20.8% Peace officers and fire- fighters – 23.8 Highway Patrol – 33.4% Schools – 9.9%
Employee	Any rate between a minimum of 2% and a maximum of 10% of their superannuation salary. Members can vary their percentage rate of contributions at any time. The default level of contribution is 5%.	Retirement age = 65: 6%, 7.5% and 8.8% according to income level Retirement age = 60: 7%, 7.3%, 8.5% 9.8% according to the income level	6.05 %	7.19%	6.57%	7-9%

(*) The contribution rates will rise annually from October 2004.

Source: Replies to the OECD Questionnaire on Civil Servants’ Pension Funds.

In Australia, PSS benefits are expressed in terms of “benefit multiples” which, in most cases, are derived from the membership’s period, salary and contribution rate. The employer component of the benefit is largely unfunded and the employer is liable to pay the full benefit entitlement at the point it becomes payable. The amount required to be paid generally varies in relation to the level of member’s contributions and interests. The employer contribution rises when fund investment returns are low and falls when investment returns are high. While the employees can choose their contribution, employers are required to meet the notional accruing costs of their members. The contribution rate is calculated to ensure that employer-financed benefits from the PSS would be fully funded in three years time. Agencies are funded annually for these costs, on the basis of the average cost per member and are subsequently charged for the notional PSS costs of their individual agency, which are calculated on the basis of the aggregate superannuation salaries of the agency’s employees.

In the Australian scheme, retirement benefits are paid when members cease employment after having attained their minimum retirement age of 55 and all PSS pensions are indexed every six months according to the Australian Consumer Price Index. In the Ontario’s pension scheme, the normal retirement age is 65 for most employees and 60 for police and fire workers. The benefit is 2 per cent of the member’s average earnings for the best 5 consecutive years multiplied by the member’s years of service up to a maximum of 35. Benefits are fully indexed to consumer prices, but capped at 6 per cent with a carry forward provision.

Early retirement is permitted at 55 years old after 30 years of qualifying service or if the sum of the member's age with his/her years of service reaches the factor 90.

The ABP plan offers old age, survivor's and disability pensions. An optional ABP extra pension is also available. Based on a career average system accrual rate ranges from 1.75 to 1.9 according to birth dates. As far as indexation is concerned, depending on the funding ratio, the pensions follow the increase of the employees' salaries.

In Japanese benefit plans there are disability, survivor's and old age pensions and to qualify for the old age benefit civil servants need to be insured for at least 25 years by any of the public pension systems. The legal age for pension payment is increasing from 60 to 65 years. The old-age pension amount is the result of the multiplication of working life average monthly salary valorised by 0.9 per cent and by the member's years of service. This pension formula is more generous than the one applied to private sector workers that have the coefficient equal to 0.75 per cent. In the civil servants' scheme, the valorisation of past salaries is based on the general wage index. The hitherto adjustment to the pension amount is indexed to CPI.

In CalPERS, the structure of the plan is flexible and benefits are paid according to the category of employment and type of benefit coverage contracted by an employer. Retirement benefits are calculated using a member's years of service credit, age at retirement, and final compensation (average salary for a defined period of employment). There are a variety of retirement formulas that are determined by the member's employer (state, school, or local public agency) occupation (miscellaneous, *i.e.* general office and others; safety; industrial; or peace officer/fire-fighter), and the specific provisions in the contract between CalPERS and the employer. Most part of the members are under the *State Miscellaneous* scheme that guarantees at the age of 55, two percent of final compensation for each year of service credit. The retirement age can range from 50 to 63 years old. The scheme offers different alternatives depending on coordination with the national social security regime.

Governance

The governance structures of the civil servants pension funds are more complex than the private sector and the number of members of the governing boards is relatively large to accommodate the participation of an extensive list of actors.

The Australian PSS is an exception. The PSS board comprises a chairman and four other trustees, consisting of two member's representatives, two employer's representatives and one independent chairman. All of them are appointed on a part time basis by the Minister for Finance and Administration. The Board meets at least once a month. The employees representatives are suggested by the Australian Council of Trade Unions and the employer's representatives are nominated by the Minister for Finance. The chairman is appointed by the Minister in accordance with other PSS Board members and should act independently. The trustees' payment includes their remuneration for committee representation and expense reimbursement. The minimum Board quorum for any decision is four and all decisions must be taken by at least four votes of the trustees.

ABP has four boards: the participants' council, the employers' council, the governing board and the board of directors. The participants' and employers' councils are composed of 36 members each and function as an advisory board on general policy issues. On the participants side there are 24 employees' representatives and 12 pensioners' representatives. The members are appointed by trade unions for public sector personnel and the Dutch Association of Pensioners' Organisations. The employer participation is divided proportionally over the various sectors. Members are appointed by the Association of Sector

Employers in Government, the Employers' Association for the Dutch Energy and Utility Companies and the regional water boards.

The ABP Governing Board is composed of 12 members representing the social partners (six for each side employer/employee), plus an independent non-voting chairman. Board members are not remunerated, but receive fees for attendance and expenses. Board members are appointed for four years, with the possibility of prolongation. The chairman and the secretary of this Board are selected from the appointed members to serve for a one-year term. These positions are filled in alternate years by employers' and employees' representatives. The supervisory authority must confirm that the appointed board members have sufficient expertise to perform their duties in the interest of the pension funds beneficiaries. A performance agreement has been established between the Governing Board and the Board of Directors, with clear indicators concerning operating costs, service level and investment profits. The Government Board meets monthly.

Finally, the day-to-day management of ABP is entrusted to the Board of Directors, which is composed of 3 directors and a chairman, appointed by the Governing Board. The duties and powers of the Board of Directors are regulated by the Governing Board on matters concerning the policies of ABP, including amendments to the statutory articles and the adoption of the annual report and budget. The Board of Directors meets once a week.

The OMERS Governing Board has 13 members, six representing employees, including one retired member, six employer representing employers and one representing the provincial government. The OMERS Board meets on a monthly basis. The members are appointed by the Government of Ontario (on the recommendation of the Minister of Municipal Affairs and Housing) for an appointment of three years and a maximum two terms. The members are nominated by various members' associations and unions and are remunerated on a per diem basis. The Board is accountable to the Minister of Municipal Affairs and Housing. The board decisions are taken by majority voting. The Board has five standing committees: the executive, investment, audit, pension and management committee.

In Japan, both the central and the local government civil servants pension funds are structured with a Board of Supervisors and a Board of Directors. At central level the Board of Supervisors has 16 members - 8 trade union representatives and 8 ministerial officials. They meet at least twice a year. The Board of Directors has 10 directors and three auditors, among whom six directors and two auditors can be representatives of employers. The president of the Board and the auditors are appointed by the Ministry of Finance. Currently, three directors and one auditor (representing ministries) are appointed *ex-officio*. The other seven directors (including one director representing a trade union) and two auditors are appointed by the president, after approval from the Finance Minister. The directors and auditors, who are not *ex-officio* or trade union representatives, are remunerated. The board decisions are taken by majority voting. The rules for the local government pension funds are quite similar. Basically, there are differences in the number of members. At the local level, the Board of Supervisors has 22 members with 11 trade union representatives and 11 ministerial officials and the Board of Directors has 8 members and 3 auditors.

The CalPERS Board is responsible for the management and control of the administration and investments of all CalPERS' pension plans. The Board is composed by 13 members – six elected by participants, three appointed and four *ex-officio* members. The active State workers elect two representatives. CalPERS' school workers elect one board member and another representative is elected by the personal employed by CALPERS' contracting public agencies. The retirees elect one representative and two are elected by the ensemble of all workers and retirees. There are three appointed members, including two appointed by the Governor (an elected official of a local government and an official of a life insurer), one public representative appointed jointly by the Speaker of the Assembly and the Senate Rules Committee. And, finally, there are four *ex officio* members - the State Treasurer, the State Controller; the

Director of the Department of Personnel Administration and a designee of the State Personnel Board. The Board meets on a monthly basis and has established several committees to review and report on specific programmes, projects, and issues and to make recommendations.⁹

The CalPERS board has approved organisational statements that guide the daily action of the organisation, including mission statements, vision, guiding principles (see Box 1), core values statements, a strategic plan, and a customer-focused business philosophy. These statements strengthen the institutional personality and contribute to mitigate political risks related to the presence of the government as sponsor. CalPERS have also introduced a business plan, establishing specific business objectives targeted for the next three years in the areas of customer service accessibility, availability, and responsiveness to members and employers; financial education; efficiency and effectiveness of retirement and health programs; long term performance returns; benefit plan design and others.

Box 1. CalPERS' Guiding Principles

- Designing and administering the highest quality, secure, and innovative programs.
- Delivering retirement, health, and other benefits and services in an equal, accurate, courteous, professional, and prompt manner.
- Providing meaningful information and education to all System constituents in a timely manner.
- Attracting, developing, and retaining a competent, creative, and highly motivated workforce
- Obtaining the highest return on our investment portfolio to survive, prosper, and grow in a safe and prudent manner.
- Ensuring that all benefits are appropriately funded.
- Maintaining public trust by being an ethical, sensitive, effective, and cost efficient organisation in service to employers and employees alike.
- Sustaining its role as a respected leader in the public pension and benefits industry.

Source: CalPers (available at <http://www.calpers.ca.gov/index.jsp?bc=/about/mission/guiding-principles.xml>).

External audits are required in all surveyed pension funds, except Japan. In Australia, the PSS Board is mandated by legislation to use the Australian Auditor-General as its auditor. The Auditor-General's Office contracts an external and independent party to conduct the audit. The Board provides a written brief to the auditor with respect to the annual audit and ensures that all advice from the Auditor is given due consideration, which is documented through committee or Board minutes. The external auditors currently provide regular tax and attestation services that are tied to the annual financial reporting cycle.

In Canada, the audit work includes a review of the internal controls over those processes which generate financial statement data and then substantiates OMERS quantitative and qualitative information in the financial statements. Auditors also perform audits of all OMERS subsidiaries and assist with the preparation of subsidiary tax returns. Finally, the auditors review the foreign content tax filing which OMERS is required to file with Canada Customs and Revenue Agency.

In Calpers, there are internal and external auditing services. The internal office performs comprehensive assurance reviews and functions as a consulting resource to assist the Board and other

members of management in achieving both approved business goals and effective discharge of their responsibilities. Besides internal auditing, CalPERS publish annually a report of independents accountants.

Custodial and actuary services have been required by the civil servants pension funds governing boards surveyed in Australia, Canada, the Netherlands and US (California). In Australia, the custodian's responsibilities in relation to investment management include settlement of trades, physical custody and safekeeping of securities, collection of dividends and account preparation. The custodian holds the assets, collects and disburses dividends; maintains consolidated accounts and tax records for the Fund; and reports to the Board on compliance monitoring, individual fund manager performance and aggregated investment returns. Actuaries may be engaged to provide actuarial advice as required by the Board from time to time.

The external custodians and actuary are appointed by the OMERS Board. The role of the custodian includes: (i) holding, delivery and registration of securities; (ii) cash management services; (iii) appointment of agents and sub-custodians; (iv) corporate action processing; (v) collection of income and tax reclaim processing; (vi) securities lending; (vii) proxy delivery and execution; and (viii) reporting.

In CalPERS the actuarial services are internal to the pension fund structure. The Chief Actuary and his team perform annual actuarial evaluation of all CalPERS plans. The actuarial assumptions, methods, parameters and results are published in the annual financial report.

The structure of the pension funds varies widely from complete outsourcing (PSS) to almost total in-house (OMERS) activities, but always with at least some outsourcing with respect to asset management. The Australian PSS is structured as a Board and outsource all functions. ABP subcontract contributions collection and approximately 20 per cent of asset management. The Japanese civil servants pension funds contract out 39.3 per cent and 10.8 per cent of investment management at central and local levels respectively. In OMERS, 17 per cent of asset management is outsourced whilst other functions are performed in house (Table 4).

Table 4: Outsourcing functions in the civil servants pension funds

Pension funds main functions	PSS	OMERS	ABP	FNPSPMAA and PFALGO	CalPERS
Investment management	OUT	IN/OUT	IN/OUT	IN/OUT	IN/OUT
Contributions collection	OUT	IN	OUT	IN	IN
Verification of eligibility conditions	OUT	IN	IN	IN	IN
Benefits payments	OUT	IN	IN	IN	IN
Management of member's accounts	OUT	IN	IN	IN	IN
Services provision for members	OUT	IN	IN	IN	IN/OUT

Source: Replies to the OECD Questionnaire on Civil Servants Pension Funds.

Pension funds managers are required to comply with at least a conflict of interest code that may include some ethics provisions. Only ABP also require compliance with corporate governance and prudent investments code. In other funds, such as PSS and OMERS, governance code provisions are included in the proxy voting guidelines (table5).

Table 5: Codes for pension funds managers

	PSS	OMERS	ABP	FNPSPMAA and PFALGO	CalPERS
Ethics code	NO	YES	YES	YES	YES
Corporate Governance code	NO	NO	YES	NO	YES
Prudent investments code	NO	NO	YES	NO	YES
Conflict of interest code	YES	YES	YES	YES	YES
Proxy Voting Guidelines	YES	YES	YES	NO	YES

Source: Replies to the OECD Questionnaire on Civil Servants Pension Funds.

Civil servants pension funds have played an important role in corporate governance activism and in the adoption of socially responsible investment patterns. CalPERS has an extensive experience in promoting the adoption of corporate governance principles leading to changes in corporations all over the world. OMERS hold shares of approximately 300 Canadian companies and more than 1900 globally and have encouraged them to improve corporate governance. The pension fund has issued proxy voting guidelines to orient the vote of the companies' board members. Since 2002, the PSS Board has adopted proxy voting guidelines and has required Australian companies to improve auditing and reporting on environmental risks, workplace health and safety risk management and the governance and disclosure of energy use. According to recent polls, 2/3 of Australian companies had changed audit governance practice in response to the PSS actions. ABP uses proxy voting not only to homogenise participation toward improving governance, but also to reduce the costs of physical participation in shareholders meetings throughout the world.

CalPERS proxy voting guidelines are based on corporate social responsibility and corporate governance principles. In order to act as shareholder, the pension fund's representatives in the boards consider issues related to: human rights; promotion of equal gender, race, age, ethnical and religious beliefs opportunities; decent work conditions; health and safe work place; fair competition, including property rights, and others. On the corporate governance front, CalPERS take into consideration: (i) ultimate accountability to shareholders; (ii) transparency and adequate provision of material to encourage shareholder participation; (iii) long term strategic vision and (iv) adoption of best practice codes.

The PSS Board has issued proxy votes in the companies in which it invests. The fairness of proposals affecting shareholder rights are judged in the context of the organisation's legitimate obligations to all parties (including shareholders, creditors, management, employees, customers and suppliers); and the likelihood of the proposal generating a reasonable return to shareholders. The PSS board is resistant to changes in the capital structure that interfere with the proper flow of profits to shareholders and to changes or current arrangements with respect to the voting rights that restrict shareholders control over the Board and over major capital transactions. In the proxy voting guidelines, there are also provisions related to the appointment of directors, compensation arrangements, conflicts of interest's code and adoption of corporate governance international standards.

OMERS presents detailed, extensive and precise voting recommendations based on guidelines on the structure of the board of directors, executive compensation, takeover protection, shareholder rights and social responsibility. With respect to the structure of the board, OMERS' recommendations include provisions on the independency of the board, nominating process, size and effectiveness, confidentiality, end of cumulative voting, separation of board and management roles and full alignment of management and shareholder values. OMERS have established social responsible, ethical and environmental clauses. The pension fund strongly supports the adoption of measures to protect the biosphere, made sustainable use of natural resources, reduce waste and avoid misuse of energy. It also recommends votes in support of pursuit of fair human rights and labour practices.

ABP uses proxy voting disclosure to rationalise the participation in shareholder's meetings, reducing physical participation and thus operational costs. The votes are cast electronically based on the information available supplied by service providers based *in loco*. Since January 2004, all votes by the corporation have been disclosed on its website and any person can access the ABP's shareholders' voting behaviour.

Disclosure is extremely important to these types of plans in order to avoid the political misuse of the reserves and the creation of unfunded liabilities that may be borne by tax-payers. This argument is reflected in potential controversies and problems that usually arise when public agencies are supervised by another public entity. Some authors report that this is the major problem with government workers' provident funds in Southeast Asia (*e.g.* Indonesia, Malaysia and Singapore).¹⁰

All surveyed pension funds declared the presentation of minimum disclosure requirements and the pursuit of disclosure policies. In Australia, a product disclosure statement is requested to be given to members on joining the PSS, which sets out the main features of the scheme and informs members about a range of matters. During contributory membership each member must be given an annual statement about their account in the fund providing a range of information about the scheme and, upon leaving the Fund, each member must be given an exit statement. In OMERS there are also minimum legal disclosure requirements set out in the *Pension Benefits Act*.

Dutch employees receive annually by mail a document called "Individual Pension Statement", also available on the internet with all relevant information. The employees have also at their disposal general service leaflets and individual letters for specific purposes (life-events). In mid-2003, the ABP Board adopted a transparency and communication policy framework, based on external research into the need for greater transparency and a benchmark survey of a number of pension funds and other financial institutions. This policy framework has now been translated into a concrete action plan, which is designed to improve the annual pension statement and the information provided via customer publications and the internet. ABP is also participating in a number of national projects to increase pension awareness.

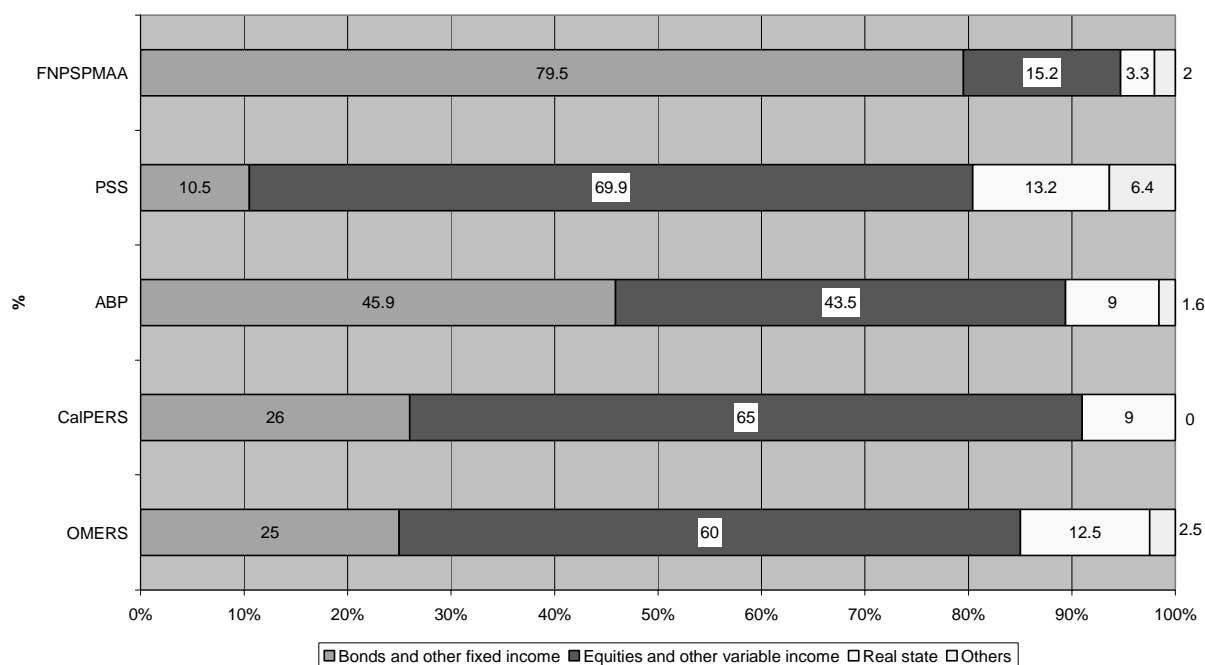
Investments and funding issues

All surveyed pension funds have written investment policies revised annually with participation by external advisors. Asset liability methods are used by ABP, CalPERS and OMERS and assets are evaluated by marked-to-market methods and book value.

ABP has the most aggressive investment target of 7 per cent in the long run. For the other pension funds, investment targets are 4 per cent (Japanese civil servants pension funds), 4.25 per cent (OMERS), 4.5 per cent (PSS) and 4.75 per cent (CalPERS).

In spite of differences in asset allocation, there is a growing interest in private equities, infra-structure projects and hedge funds. In 2003, CalPERS, PSS and OMERS presented assets portfolios more exposed to equity investments (Figure 1). In its strategic plan, PSS intends to reduce its equity exposure from 70 to 55 per cent, and increase investment in bonds from 10.5 to 23 per cent. The PSS Board has also expressed interest in changing the structure of the equity portfolio, by increasing exposure to alternative investments, more specifically to Australian private equity and infrastructure projects.

Figure 1: Portfolio Allocation of Selected Civil Servants Pension Funds in the OECD – 2003



Source: OECD Questionnaire on Civil Servants Pension Funds.

OMERS' investment strategy for the next 10 years combines reducing the exposure to public stock and bond markets, maintaining a large real estate portfolio and shifting capital to private equity and infrastructure assets. The pension fund intends to reduce investment in publicly trade stocks and bonds from 80 to 63 per cent of total assets. OMERS is already one of the main investors in the Canadian infrastructure sector including nuclear power stations, bridges, tunnels and high speed trains. They have also reported to have provided infrastructure investment for 16 elementary and secondary schools and health care. According to OMERS' annual report these investments may require large amounts of capital committed for up to 30 years, but generate reliable returns and cash-flows that match long term obligations.

CalPERS' investment policies are decided by the Board's Investment Committee, CalPERS staff, and third party contractors. Each policy goes through a revision process by the Investment Committee's Policy Subcommittee and is then submitted to the full Investment Committee for final approval.

CalPERS has established specific provisions concerning Economically Targeted Investments (ETIs). The Board considers as a secondary objective the promotion of economic growth and well-being in California and its localities, including industrial and business growth, job creation and housing. The Board consider only ETIs which, when judged solely on basis of economic value, would be financially comparable to alternatively available investments on a risk adjusted basis. The potential collateral benefits are considered neither as part of the investment return nor of the risk adjustment. The goal for ETIs is 2 per cent of fund assets. Designated external consultants and advisers are contracted to analyse legal sufficiency, identification of potential conflicts of interests and investment sufficiency.

ABP is revising its asset allocation strategy towards increasing hedging on dollar exposure and the allocation of funds to alternative categories (such as private equity and commodities, private bonds and

mortgage-related products) and decreasing the share allocated to government bonds and listed equities. ABP has established a specialised team – the Alternative Investment Platform – to investigate, assess and obtain extra gains in market niches of alternative investments, including real estate, private equity, commodities, hedge funds, index-linked bonds and specific active mandates such as alpha funds.

The investments of the Japanese civil servants pension funds are largely concentrated in government bonds. Japanese regulations stipulate that at least 30 per cent of the local government pension funds assets must be invested in the Japan Finance Corporation for Municipal Enterprises and 34 per cent of FNPSMAA assets must be invested in government-run investment programs. Moreover, the governing board has decided that assets should not be invested in equities, except when the investment is done by external trust funds that manage part of the portfolio.

The current funding ratio of ABP is 112 per cent, 100 per cent at the OMERS, 70 per cent at the Japanese civil servants pension funds and 95 per cent at CalPERS. In case of underfunding, in Australia and Japan the employer bears responsibility for contributing additional funds. In Japan, despite of the large amount of accumulated assets, the system is technically underfunded and is running on pay as you go basis. In the central government scheme assets cover 70 per cent of liabilities. Currently there is a bill of law being discussed proposing changing the criteria for benefit adjustment by taking into consideration the pace of decrease in working population and the lengthening of life expectancy. In the Australian PSS, the sponsor explicitly bears any market risk by increasing the notional contribution to guarantee the defined benefit.

In OMERS both active members and participating employers bear the responsibility equally. In the case of a surplus, OMERS allocates a portion of the surplus equivalent to 5 per cent of the liabilities to a Funding Stabilisation Reserve (FSR) as a cushion against volatile investment returns or changes in liabilities. Another portion is allocated to a Contribution Deficiency Reserve to assist the management in future contribution shortfalls. The FSR is used in case of underfunding and if the imbalance is not solved, employee's and employer's contributions might be adjusted.

ABP has recently adopted a dynamic contribution/indexation matrix to face eventual underfunding situations. When the funding ratio is low, the matrix is used to determine how much indexation has to be reduced and how much contribution should be increased. According to 2003 calculations, considering contributions fixed, the full benefit's indexation could be resumed at a funding ratio of 114 per cent. However, as the main variables change annually, the matrix itself is also adjusted and the calculations are based on the expected funding ratio.

The matrix has been used by the governing boards to pursue commitments on setting the main parameters of the system. In 2004 public sector employers and trade unions agreed on that instead of on rising the contribution rate from 15.2 to 22.4 per cent and reduce pension indexation, the benefit calculation should be switched from final-basis salary to average salary.

Conclusions: Good practices in civil servants pension funds

The surveyed cases provide some institutional features that can be considered as good practices in mitigating the risks of civil servants pension funds.

As suggested by the Dutch experience, civil servants pension funds may best be organised as private and autonomous institutions, submitted to the same regulatory and supervisory framework as applied to private sector workers. The private entity legal status may contribute to insulate pension funds decisions from political pressure and inappropriate interference from the government in pursuing its objectives. At same time, if the supervisee is "out of the government", supervisory agencies are likely to be more

effective in the promotion of compliance with regulations. In case of public bodies, institutional and operational independence should be guaranteed, with segregated assets and accounts. In the case of CalPERS, there are provisions in the State constitution preventing the pension fund against political pressures.

Multi-sponsoring and centralised arrangements should be encouraged, as shown in the cases of ABP, PSS, CalPERS, OMERS and the Japanese civil servants' pension funds. The advantages of a centralised, multi-sponsored entity are related to economies of scale and the scope of the pension provision. Moreover, such institutions are likely to be more transparent, with better governance and easier to supervise. In other countries, fragmented pension funds organised by specific public institutions (e.g. ministries, public agencies) or branches may veil special retirement conditions for small groups, increase administrative costs and reduce the overall transparency and efficiency of the pension system.

Defined contribution arrangements may be preferable in order to alleviate the transfer of unfunded liabilities to taxpayers and encourage member's participation in the pension fund's governance structures. Member's participation is also important to avoid misuse of pension fund reserves and investment decisions not primarily related to retirement.

The process for formulating and executing pension fund investment and pension fund as shareholder voting behaviour should be open and transparent and investment outsourcing is recommended. In all cases, there are written investments policies designed with the participation of external experts and revised periodically. Generally, pension board decisions are released and voting behaviour is oriented by proxy voting guidelines. ABP can be considered a reference in promoting transparency regarding voting behaviour given that it publishes all votes taken by the corporation on the website.

Special attention should be given to Economically Targeted Investment (ETIs). CalPERS releases specific investment statements for ETIs and sets a maximum portfolio allocation limit of 2 per cent for this asset class. External evaluation is required and the investment decision should be taken by comparing to alternatively available investments on a risk adjusted basis. In this comparison, the potential collateral benefits should not be considered either as part of the investment return or of the risk adjustment.

In order to accommodate the participation of a widespread list of stakeholders, civil service pension funds involve several, large governing boards with complex governance structures. Most funds comply with OECD good practices in governance related to the implementation of external auditing, actuarial and custodian services. Although corporate governance codes are not implemented in all cases, the pension funds have adopted conflicts of interests and ethical codes.

Finally, specific financial literacy strategies need to be designed to convince and orient taxpayers who are not directly involved in pension fund management to take steps to ensure that the fund managers do not act in a way that is contrary to the best interests of the plan members and beneficiaries. Public awareness and understanding may induce better discipline and good communication mechanisms improve organisational performance. Good public accountability, transparency and financial literacy should promote stakeholders' participation in filling eventual supervisory gaps that may arise with respect to government workers' pension funds. In some cases, audit and annual reports are not enough for participation and a broader communication policy is necessary.

NOTES

- ¹Pensions & Investments/Watson Wyatt Global 300 Survey (2005), available at <http://www.watsonwyatt.com/europe>
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- ¹⁰ Asher, M. (2003), *Governance and Investment of Provident and Pension Funds: The Case of Singapore and India*. Presentation prepared for the Second Public Pension Fund Management Conference, World Bank, Washington, May 5-7, 2003.