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Investing in Private Financial Assets to Address Longer-term Needs

by
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1. Introduction

In preparation for the 2002 meeting of the OECD Working Party of Senior Budget Officials, an *ad hoc* Meeting on Investing in Private Financial Assets to Address Longer Term Needs was held in Paris on 4-5 April 2002.

Eight countries participated in the meeting with case studies of their national experiences: Australia, Canada, Chile, the Netherlands, New Zealand, Norway, the United Kingdom and the United States. France attended the meeting as well. The meeting was chaired by Mr. Paul Posner, Managing Director, General Accounting Office, United States.

This note summarises the discussion at the meeting in five sections:

- Why are countries investing in private financial assets?
- What have been the big "threshold" questions that countries have considered before moving in this direction?
- What are some of budget treatment issues that arise from this?
- What are the governance arrangements that countries have put in place for investing in private financial assets – *i.e.* who decides where to invest?
- What are the specific reporting requirements that countries have put into place to ensure the transparency and accountability of such investments?

2. Why are countries investing in private financial assets?

The motivation for investing in private financial assets varies from country to country but the discussion at the meeting revealed four major and clearly defined categories. A number of other motivations were also voiced at the meeting but they are conceptually different from the first four and do not amount to a major category in this context.

2.1. Pre-funding long-term pension expenditure

The single most common motivation for investing in private financial assets by governments is to pre-fund long-term pension expenditure. Over the next decades, OECD member countries will experience a significant ageing of their populations. This will lead to a substantial increase in age-related public expenditure, notably for pensions. Currently, member countries are, with significant exceptions, enjoying a rather healthy fiscal position. By accumulating private financial assets during this time period, member countries can mitigate the fiscal consequences when these long-term expenditures come to fruition as they will be able to draw down on these assets.

How such schemes are implemented in concrete terms can vary greatly. Some countries have applied pre-funding to general (Social Security) old-age pensions, whereas others have only done so for their civil service pension schemes. In some countries, the government decides the investment strategy and invests government funds on its own behalf. Other countries have created (or are considering) individual accounts, where funds are put under the ownership of individuals who decide the investment strategies for their pre-funding directly. These issues are elaborated on in the next section.

2.2. *Pre-funding insurance obligations*

Another main reason for governments to invest in private financial assets is in order to pre-fund insurance obligations. The governments of several member countries have established special insurance funds that provide cover against various calamities that private sector insurers are not willing to provide. The most notable of such insurance funds are ones for cover against damage caused by natural disasters – such as earthquakes, volcanoes and avalanches. When such calamities occur, the outlays from the government will be great. The objective of pre-funding such obligations is that a fund balance will be built up over time in order to be drawn on when the calamity strikes.

2.3. *Sustaining wealth derived from natural resources*

A small group of member countries enjoy significant revenues from natural resources (petroleum, copper, etc.). They have decided for various reasons to establish funds whereby the proceeds of these resources are invested for the benefit of future generations. These funds are generally not hypothecated (*i.e.* the resources would not be dedicated to one issue, such as pre-funding long-term pension expenditure). These funds also serve a macroeconomic stabilisation function.

2.4. *Maintaining government bond markets*

A small group of member countries have been able to reduce their outstanding government debt to such a degree that the existence of an effective government bond market is in question. They have taken the view that it's important to maintain a government bond market and have as a result decided to invest in private financial assets, rather than pay down their debt in total. The motivations for this include strengthening the domestic capital markets, preparing for the possibility that the government may need to borrow again and providing a secure, long-term investment vehicle for other actors in the capital markets.

2.5. *Other*

A number of other reasons motivate governments to invest in private financial assets. These may include short-term cash and debt management purposes, the creation of endowed foundations to carry out public policies and investments for regional development purposes. These are, however, conceptually different from the above listed categories and are beyond the scope of this paper.

3. What have been the big "threshold" questions that countries have considered before moving in this direction?

Before moving on to a discussion of implementation issues of investing in private financial assets, it is important to discuss some of the major "threshold" questions that countries have addressed in order to judge the desirability of doing so.

3.1. *Does this delay necessary reforms to programs?*

It is generally recognised in most countries that governments will have to lower benefits, tighten eligibility criteria and/or raise taxes for old-age pension programs in order to deal effectively with the fiscal effects of the ageing of the population. The question arises whether partially pre-funding old-age pensions may delay these needed reforms.

While it is the case that a portfolio of private assets will reduce the need for benefit cuts or tax increases, the accompanying political statements often imply that no such action will be required. As a result, pre-funding mechanisms may often give a false sense of security about the sustainability of current programs and delay the necessary reforms to the programs.

For example, when New Zealand created the New Zealand Superannuation Fund, it was announced that the current levels of benefits would be maintained in perpetuity and that indexing would be linked to wages rather than prices, which increases the level of benefits. Examples from other countries have involved similar political statements, albeit generally more implicitly stated.

3.2. *Is this an appropriate role for government?*

A fundamental philosophical question for countries to consider is whether investing in the stocks and bonds of private sector companies is an appropriate role for governments to be playing. Large-scale government investments could well distort the operations of capital markets as well.

For example, the Clinton Administration in the United States had proposed that 15% of the balance of the Social Security Trust Fund be invested in private equities in order to capture the higher rate of return experienced there. The current Bush Administration has rejected this and proposed instead that a portion of payroll taxes levied for Social Security be placed in individual accounts that are owned and managed by the account holder rather than the government.

3.3. Is this realistic when countries still have debt?

At the moment, no OECD member country is free of debt on a gross basis. The question arises whether it is realistic for governments to be investing in private financial assets at the same time as they carry debt on the balance sheet. As was noted in the previous section, some countries invest in private financial assets in order to maintain a government debt market. However, most member countries have levels of debt significantly higher than that.

Only if pre-funding mechanisms can be structured and operated in such a manner as to increase overall national savings will they be effective from a macroeconomic point of view, *i.e.* there is a risk that additional savings in one area will be offset by reduced savings in other areas. The possibility that overall national savings can be achieved should not be precluded but it certainly cannot be assumed.

The Netherlands opted for the creation of a "virtual" fund. The Netherlands has calculated that in order for it to be able to bear the fiscal costs of the ageing of the population, it will have to run budget surpluses in the order of 1.25-1.75% of GDP for the next 25 years. The resultant savings in interest expenditure will almost finance in total the extra costs due to the ageing of the population, including the Old-Age Pension Fund. This fund is credited with an IOU (promissory note) from the government equivalent to the savings in interest expenditure each year as described in the Old-Age Pension Fund Act. The Netherlands believed that such a virtual fund was more practicable and politically acceptable than "real" investing in financial assets. This does, of course, preclude the fund from enjoying the benefits that a higher rate of return from investments in private assets would bring. It also precludes the risks associated with investing in private assets.

4. What are some of budget treatment issues that arise from this?

Investing government funds in private assets raises a number of conceptual budget issues to address. The budget treatment of private assets could influence whether the accumulation of private assets achieves its desired objective.

4.1. How to ring-fence from the rest of budget?

When a government attempts to save for the future, the potential exists that the accumulation of resources will generate demand for spending increases or tax cuts. This is true to some extent whether the saving takes the form of paying off debt or accumulating private assets. If the government does decide to start accumulating private financial assets, it will face the challenge of ensuring that these assets are kept separate from the "normal" budget. Experience has shown that it is very difficult to ring-fence parts of the budget in practice, but allocating (or hypothecating) assets to a specific public policy objective, such as pre-funding old-age pensions, may be a unique window of opportunity.

Ring-fencing is closely related to how the government decides to account for these assets. For example, will it carry the assets directly on the balance sheet or will special funds outside the government be created that will carry the investments? The ring-fencing of assets would likely be enhanced if the assets were administered according to a special governance arrangement (see next section). Investing in private assets rather than government securities may also help ring-fence the assets, depending on how those assets are portrayed in the budget.

4.2. Aggregate fiscal measures

The aggregate fiscal measures applied in most member countries focus on gross measures of debt, rather than net measures of debt. If governments accumulate significant financial assets, which would not count against the level of debt, countries may not consider investing in financial assets.

The European Union's Maastricht Treaty, for example, explicitly states that all debt criteria should be based on the gross measures. The reasons for this of course being that government financial assets have historically tended to consist of lending to entities and programs that others would not lend to and have therefore been of very low quality, whereas the debt was very real.

4.3. Treatment of individual transactions

The budgetary treatment of individual transactions can also strongly affect the operations of funds that invest in private financial assets. The two major budgetary choices are as follows:

First, will the purchase of private financial assets be recognised "above the line" as an expenditure or will it be reported "below the line" as a financing (capital injection) item, or will it be held totally outside of the budget? Practices among member countries encompass the entire spectrum.

For example, the Canada Pension Plan is not part of the federal government's revenues or expenditures and therefore does not directly affect the federal government's budget.[1] Contributions to the New Zealand Superannuation Funds are reported as a financing (capital injection) item in the budget and financial statements. The rationale behind this is that the government is setting money aside in order to finance a future expense, rather than this being itself an expense. This would appear to be the interpretation for all governments operating under an accrual basis. For countries operating under a cash basis, contributions to purchase assets would generally be recorded as an outlay. However, accounting treatment under a cash basis are more flexible and could therefore be amendable.

Second, and applying principally to countries that apply accrual accounting and budgeting standards, is how assets and liability are valued and how any changes in these values are reported. For example, if the value of the portfolio of private financial assets decreases, will this decline carry forward to the government's consolidated financial statements as an extraordinary loss or will this be kept outside of the statements? Some investment income (such as from derivative transactions) may be reported below the line, whereas other investment income is reported above the line. This may influence the choice of investments made.

5. What are the governance arrangements that countries have put in place for investing in private financial assets – *i.e.* who decides where to invest?

When it comes to investing in private financial assets, the overriding governance principle is to insulate the management of the investment portfolio from political considerations. This is attempted by several measures.

5.1. *Institutional structures*

The authority for the conduct of the investment portfolio is generally delegated to a board of directors that is to operate completely independently of political consideration. The key question is how members of this board of directors are selected and how the law defines their responsibilities.

In the United States, the Federal Retirement Thrift Investment Board oversees the Thrift Savings Plan, a voluntary defined contribution retirement plan for federal employees. The board consists of five part-time presidential appointees who serve four-year terms and a full-time executive director selected by those appointees who serves an indefinite term. Each of these persons is required by law to have "substantial experience, training and expertise in the management of financial investments and pension benefit plans". Furthermore, the law established a fiduciary responsibility on the above individuals. They must act solely for the benefit of the participants and beneficiaries. This is designed to insulate them from political pressure. A breach of these responsibilities would make them civilly liable.

The Canada Pension Plan Investment Board consists of a 12-member board of directors, who are appointed by the Minister of Finance and serve renewable three-year terms. They are responsible for managing the equity portfolio of the Canada Pension Plan. Members may not be removed from office except for cause. According to legislation, "The minister shall have regard to the desirability of having directors who are representative of the various regions of Canada and having on the board of directors a sufficient number of directors with proven financial ability or relevant work experience such that the board will be able to effectively achieve its objects". Although not required to do so, the Minister of Finance has appointed a nominating committee to recommend names to him to fill positions on the board. The act further stipulates that board members must "act honestly and in good faith with a view to the best interests of the board; and… exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".

The New Zealand Superannuation Fund has a five-member board of directors (may be expanded to seven-member) who are appointed by the Minister of Finance. Members may be appointed for terms of up to five years. They may then be re-appointed for subsequent terms. The minister may remove board members at any time. The minister may only appoint people who have "substantial experience, training and expertise in the management of financial investments" and have been recommended to him by a Nominating Committee, which he must establish and that must "comprise not less than four persons with proven skills or relevant work experience that will enable them to identify candidates for appointment to the board who are suitably qualified". According to the act, members of the board "must act in good faith, with reasonable care, diligence and skill; and with honesty and integrity".

The Petroleum Fund Law states that the Ministry of Finance is responsible for the management of the Petroleum Fund. Within the strategic guidelines set by the ministry, the operational management of the fund has been delegated to the Norwegian Central Bank. In addition to the Ministry of Finance's guidelines for the Petroleum Fund, an agreement has been drawn up that regulates the relationship between the ministry and the bank in connection with the management of the fund.

5.2. *Determining investment policies and objectives*

The major duty of the board of directors is to determine the investment policies and objectives of the portfolio that they are managing. There are differing views on the merits of debt and equity purchases. The degree of freedom afforded in legislation varies significantly from country to country.

In New Zealand, the board must invest the fund on "a prudent, commercial basis… consistent with best-practice portfolio management, maximising return without undue risk…" The board may not take a controlling interest in any enterprise. The Minister of Finance may issue directions to the board and the board must "have regard" to any such instructions. The minister may not give a direction which is inconsistent with the duty to invest on a prudent and commercial basis. How this wording applies in practice has not been tested.

The Canada Pension Plan Investment Board must invest in "assets with a view to achieving a maximum rate of return, without undue risk of loss". The board, which invests only in equities, may invest 70% in Canadian corporations and 30% in foreign corporations. These limits apply to all pension funds in Canada. The national and provincial Finance Ministers may make specific regulations "respecting the investments the board and its subsidiaries may make". There are, however, stringent thresholds for such a regulation to effect as it "has no force or effect until the appropriate provincial minister of each of at least two-thirds of the participating provinces having in total not less than two-thirds of the population of all of the participating provinces has approved the regulation". During its early years, the fund could only invest passively in Canadian equities – that is, through stock index funds that replicated established stock exchange indices. That restriction, set by the national and provincial Ministers of Finance, has now been reduced. Half of the domestic portfolio may be invested actively in individual companies and it is expected that this restriction will be removed entirely in the near future.

In the United States, the Federal Retirement Thrift Board must pursue "prudent investments suitable for accumulating funds for payment of retirement income" and involve "low administrative costs". The board may only invest passively. For example, when it comes to equities, it may only invest in a portfolio designed to replicate the performance of an index. "The board shall select an index which is a commonly recognised index comprised of common stock the aggregate market value of which is a reasonably complete representation of the United States equity markets." It may also invest in bonds and foreign stocks following similar criteria. According to the board: "The philosophy of indexing is that, over the long-term, it is difficult to improve upon the average returns of the market. The investment management fees and trading costs incurred from passive management through indexing generally are substantially lower than those associated with active management. Passively managed funds also preclude the possibility that political or other considerations might influence the selection of securities."[2]

The Ministry of Finance establishes investment guidelines for the Norwegian Petroleum Fund. At present they are that: fixed income instruments (bonds) account for 50-70% of the portfolio and equity instruments account for 30-50%. All of this investment should take place outside of Norway. A geographical guideline for the fund is also stipulated. Europe should account for 40-60%, the Americas for 20-40% and Asia/Oceania for 10-30%. These strategic choices are reflected in a benchmark portfolio. This portfolio is a "virtual" fund, consisting of equity and bond indices for the various markets in which the fund is invested. The ministry has defined limits for the maximum variations permitted relative to the benchmark portfolio. The limit is defined as a maximum expected tracking error of 1.5%. The benchmark is also used to assess the central bank's performance. This tracking error means that the room for active management is limited. The fund should also not own more than 3% of any single company.

5.3. *Role of outside fund managers and the exercise of voting rights*

The fact that the boards of directors establish the general investment policies and objectives of the funds does not mean that they are directly involved in the daily management of the funds. Rather these are generally contracted out to professional fund managers. Similarly, the exercise of voting rights generally rests with these outside fund managers. This is designed to reduce the risk of government experiencing moral hazard problems and reduce rent-seeking by private corporations.

In the United States, the day-to-day management of the funds is carried out by outside fund managers who are selected in a competitive tender. They manage the funds in accordance with the investment policies and objectives as described above. The fund managers are responsible for exercising the voting rights associated with the stock that they manage. They are to vote them in the best interest of the owners of the securities (*i.e.* plan participants and beneficiaries), as they determine. The United States legislation specifically provides that "the voting rights associated with the ownership of securities… may not be exercised by the board, other government agencies, the executive director, a federal employee, member of Congress, former federal employee or former member of Congress".

In New Zealand, it is at the board's discretion whether assets are managed "in-house" or by external managers. There are no specific legal mandates for who exercises the associated voting rights, so the board may exercise them directly or delegate them. In either case it must publish what its policy is regarding the "retention, exercise, or delegation of voting rights acquired through investments". There is, however, a restriction that the fund may not have a controlling interest in any enterprise.

In Canada, external fund managers are responsible for the management of the equities in-line with the guidelines established by the board. The board has the right to vote on proposals put forward to shareholders. The board has delegated these voting rights to the external fund managers that exercise these rights in accordance with voting guidelines that the board sets.

In Norway, the investments of the portfolio may not exceed 3% of the share capital in any one company or 3% of the voting shares in any one company. The central bank may exercise its ownership rights linked to share holdings if and only if it is necessary in order to secure the financial interests of the Petroleum Fund.

5.4. *Social investing and ethical guidelines*

As the government is investing, there are strong pressures to take account of social investing considerations and to have strict ethical guidelines that would prevent them from investing in the securities of certain companies. The following examples highlight how governments have resisted this.

The Canada Pension Plan Investment Board states that it considers as eligible for investment purposes any securities or assets that are legal investments in Canada. Outside Canada, they consider as eligible for investment purposes any securities or assets of countries with which Canada maintains normal financial trade and investment relations.

In New Zealand, the law stipulates that the fund may invest in any types of securities consistent with "avoiding prejudice to New Zealand's reputation as a responsible member of the world community".

The Norwegian Petroleum Fund does not reject any types of securities, unless the instruments may be in conflict with Norway's commitments under international law. A separate subsidiary fund has been established to invest in environmentally friendly securities. This is a pilot test and the results will be evaluated after three year's time to judge its performance.

When the Federal Retirement Thrift Investment Board law was being debated in the United States Congress, a proposal that the fund limit itself to "investments likely to receive broad acceptance by participants and the public…" was rejected by Congress. This was on the grounds that this was leaving the door open to "social investment" and that fund should limit itself to "strict economic investments" only.

6. What are the specific reporting requirements that countries have put into place to ensure the transparency and accountability of such investments?

A high degree of transparency is considered imperative to secure public acceptance and maintain public confidence in the government's investment in private financial assets. This involves regular and comprehensive reporting on the activities of the funds.

In New Zealand, the board must issue a *statement of intent*, which summarises "the board's expectations about the performance of the fund over the next financial year, in sufficient detail to enable meaningful assessment against those expectations after the end of that financial year". The annual report of the fund then compares actual performance against those expectations. The Minister of Finance may require the fund to report at more frequent intervals.

In Canada, the investment board must present its investment policy and objectives at the beginning of the year and then a detailed annual report on performance against those objectives. In addition, quarterly reports must be published by the board on the performance of the equities.

In Norway, in accordance with the investment policy and objectives as stated above, a relevant benchmark index is identified by the Ministry of Finance. On a quarterly and annual basis, the central bank reports the performance of the actual portfolio against the benchmark indexes. In addition, an independent firm prepares performance reports for the fund. All of the fund's ownership is reported annually.

In the United States, the Federal Retirement Thrift Board regularly publishes information on fund performance over the preceding five years. This information is required to be made public 30 days in advance of the twice-yearly periods during which plan participants can adjust their portfolios. An independent qualified public accountant audits the plan's accounts each year for conformance and consistency with generally accepted accounting principles. The results of these audits are publicly available on the board's web page. The plan's administrative expenses are reported annually to the President and Congress.

Notes

1. It is important to note the relationship between the Canada Pension Plan and the Canada Pension Plan Investment Board. The Canada Pension Plan has a large accrual deficit and the government increased premium rates to partly offset it. All of the Canada Pension Plan investments are invested in government bonds. In order to diversify the investments and increase the rate of return, the Investment Board was created to oversee investments in equities.
2. Statement by the Honorable Roger W. Mehle, Executive Director, Federal Retirement Thrift Investment Board, before the President's Commission to Strengthen Social Security, 22 August 2001.

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