



Financial Market Trends



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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

FINANCIAL MARKET TRENDS

This publication appears two times a year with each issue providing a brief update of trends and prospects in the international and major domestic financial markets of the OECD area.

The main part of the publication focuses on analyses of, and statistics and charts on, financial matters of topical interest or longer-term developments in specific sectors of the international markets or major domestic financial markets. Periodically, a small number of articles within one field of financial sector developments, constituting the so-called “special focus” for the particular issue, may be included. Within the realms of the special focus – or on other topics of general interest – external contributors from relevant organisations in OECD member countries may occasionally be invited to contribute.

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Légendes :

.. Donnée non disponible \$ dollar des États-Unis
 – Néant

Highlights of Recent Trends in Financial Markets

I. Overview

Over the past few months, prices in major financial markets have remained strong despite further oil price increases. After major equity markets had shown a soft spot around March and April, they regained their upward trend in the second quarter. Terrorist attacks in London in July and the hurricane Katrina in the United States which hit the New Orleans region at the end of August did not disrupt markets, despite the large size of human, economic and insured losses associated with the latter event.

Financial market prices have remained strong.

Bond yields have stayed at low levels. Long-term benchmark yields in the United States have fluctuated but generally have maintained their average levels over the year to date, while yields in the Euro area have declined further, reaching historical lows in September.

Bond yields remained low in the United States and have fallen further in the euro area.

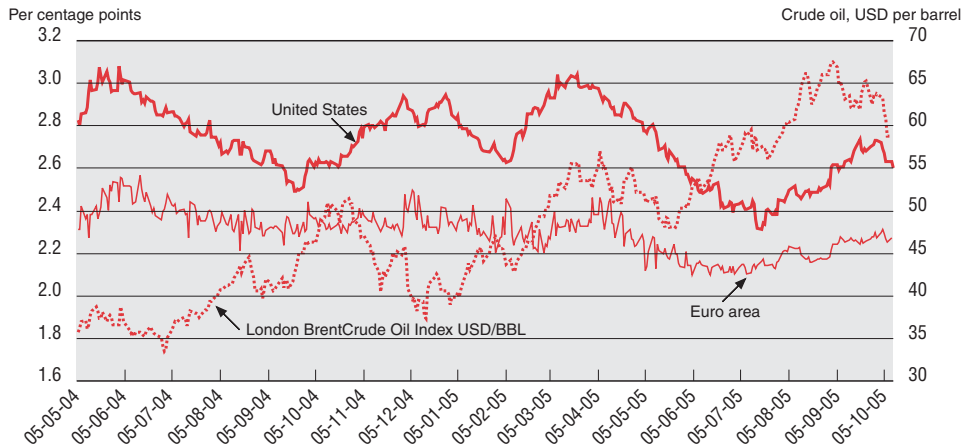
Meanwhile, credit spreads recently have eased somewhat from their compressed levels, but they remain nonetheless well below their historical averages. While uncertainties about the outlook related to increases in commodity prices and possible adjustments to global imbalances probably have not dissipated, volatility has remained low in most market segments.

Credits spreads stayed below historical averages.

The US Federal Reserve's Open Market Committee has continued its tightening cycle by raising interest rates, which along with hawkish statements by some Fed officials served to vindicate expectations for further tightening that had been implied in forward rates. A rising dollar had somewhat eased monetary conditions in the euro area, where the ECB left policy rates unchanged. Global liquidity, though slightly drying up, has remained accommodative, supporting a continuation of the "search for yield" in financial markets.

Despite continued tightening in the United States, global liquidity has remained relatively ample.

Figure 1. Implied inflation expectations and crude oil price



Note: Daily data until 10 October 2005. Implied inflation expectations ("breakeven inflation") are differences in yields between 10-year government benchmark bonds and inflation indexed bonds (Merrill Lynch government inflation-linked bond indices).

Source: Thomson Financial Datastream.

**Emerging markets
continued buoyant,
and EMBI spreads
remained
compressed.**

Emerging markets equities have again outperformed those of most of the major OECD economies over the past few months. Relatively ample global liquidity conditions and the associated continuing search for yield, together with healthy growth expectations for most emerging markets have further pushed spreads on emerging market bonds downwards, some to all-time lows. China introduced more flexibility to its exchange rate regime in July by replacing the fixed peg to the US dollar with a managed float based on a basket of currencies.

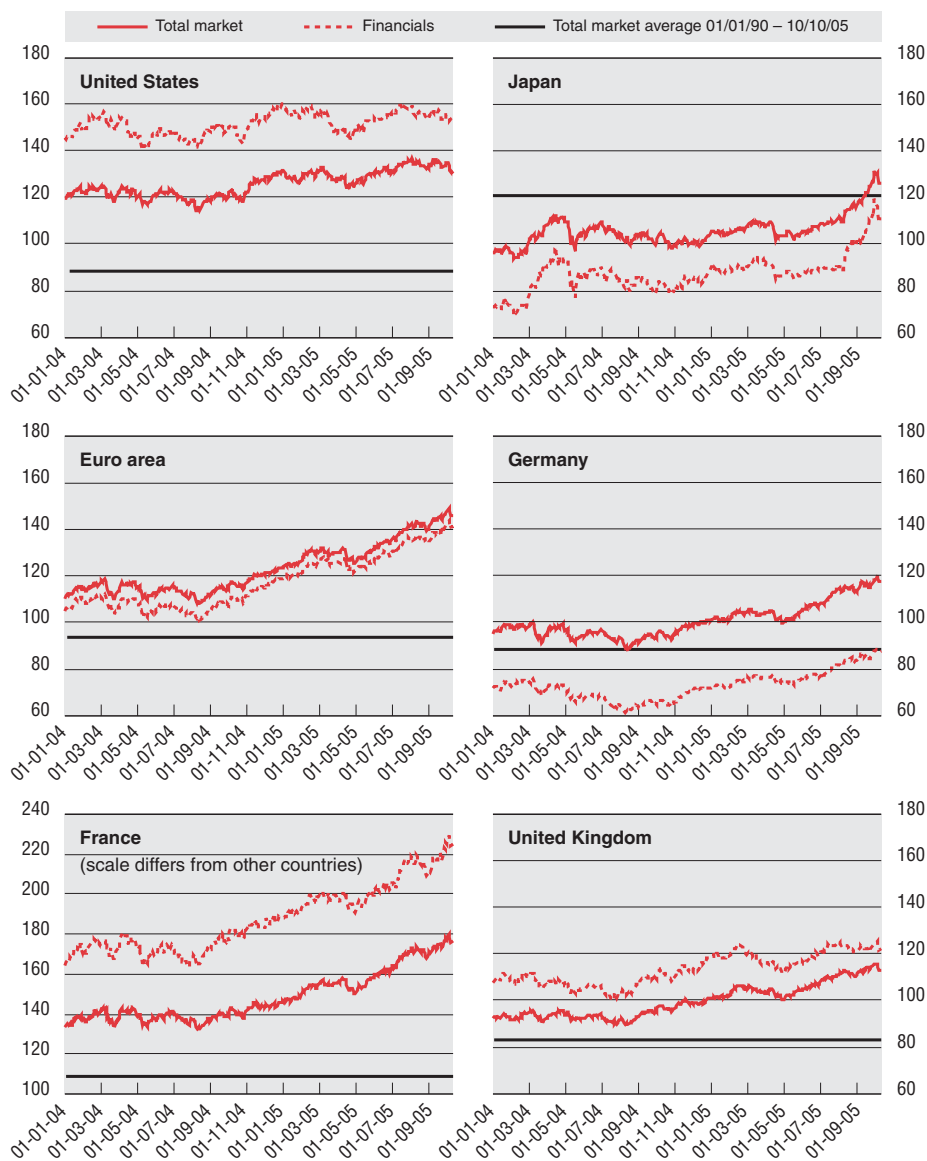
II. Equity markets

**Equity markets
in major economies
have shown
a robust
performance...**

Equity markets in major economies have shown robust performance over the past few months, reflecting a generally positive outlook and on-going confidence of investors in the economies' ability to absorb the increases in commodity prices (Figure 1) and adjustments to global imbalances (Figure 2). Earlier in the year, however, such downside risks paired with weak economic data weighed on markets in March and April and in Europe until early May. Back then, such data raised fears

Figure 2. Major stock markets

Total market and financial sector equity price indices, 1 Jan 1998 = 100



Note: Datastream indices. Daily data until 10 October 2005.

Source: Thomson Financial Datastream.

of slower US growth, while continued inflation fostered expectations that a progressive interest rate tightening by the Federal Reserve would further constrain growth. At the same time, various indications of weaker corporate profits of some multinationals added further to a negative picture, although earnings reports themselves continued to be positive.

*... backed
by corporate profits
and positive
economic news ...*

Eventually, such earnings reports formed the basis for a rebound which set in by mid-April for the US market and in May for European shares. In both economies, corporate earnings increased more than ten per cent year-on-year in the second quarter, and even though this was less than the previous year's growth, it was higher than investors had expected. These developments were also backed by other positive economic news like rising retail sales and higher job creation data which further lifted business and consumer confidence.

*... in particular
in Japan, where
growth prospects
made equity
increasingly
attractive for
foreign investors.*

Among the major markets, the Japanese market showed the strongest performance, as positive prospects for economic growth led to a large inflow of foreign capital which boosted the Japanese equity markets. Consensus forecasts for Japan's 2005 GDP growth had continuously been revised upwards, from one per cent in May to almost two per cent in September surveys. Foreigners generally have been net buyers of Japanese shares since 2003 and their appetite for the Japanese stock market significantly increased with growing optimism about Japanese economic recovery. According to some equity strategists, foreign "long-short" hedge funds had given key support to the market by deciding to "go long" on Japanese stocks. Also, while the rise in oil prices to new nominal records created nervousness about the global economy elsewhere, overseas investors were relatively relaxed about the effect of oil prices on Japan, which has been very energy efficient compared with other OECD economies.

*Regions differed
in their
performance,
with growth of
US markets weaker
than those of
Europe and Japan.*

Measured over monthly averages, the Nikkei 225 rose over 14 per cent from March until October, slightly higher than growth of the Euro Stoxx index over the same period, which increased more than 12 per cent (Table 1). Over the year, measured from December 2004 until early October this year, the Japanese index also outpaced the European index, growing over 20 per cent compared to growth over 18 per cent in Europe. Among the big euro area economies' indices,

Table 1. Overall and sectoral stock market performance in major economies

	United States	Japan	Euro area	Germany	France	Italy	United Kingdom	Canada
<i>Broad stock market indices</i>								
	WILSHIRE 5000	NIKKEI 225	DJ EURO STOXX	DAX 30	CAC 40	MILAN MIBTEL	FTSE 100	S&P/TSX COMP.
Pct. chg. Dec. 04-Oct. 05	1.7%	21.4%	18.5%	19.8%	20.6%	14.0%	14.1%	17.8%
Pct. chg. Mar. 05-Oct. 05	2.2%	14.0%	12.2%	16.1%	12.7%	8.0%	9.4%	11.1%
P/E Oct. 05 ^b	18.3	32.6	15.4	13.5	14.7	19.1	14.5	19.2
P/E avg. Jan. 90-Oct. 05 ^b	21.4	48.6	16.2	17.0	15.2	19.1	17.2	19.0
P/E avg. 90-94 ^b	17.7	48.8	14.2	17.5	12.5	17.8	15.5	19.3
<i>Telecom, Media, IT^a</i>								
Pct. chg. Dec. 04-Oct. 05	-3.7%	16.4%	5.4%	0.8%	7.5%	-3.2%	6.8%	3.2%
Pct. chg. Mar. 05-Oct. 05	1.6%	12.7%	5.4%	6.6%	8.9%	-2.9%	4.4%	3.8%
P/E Oct. 05	25.7	31.5	20.4	19.3	15.7	26.2	16.5	26.3
P/E avg. Jan. 90-Oct. 05	29.5	62.6	21.9	31.7	19.7	21.1	24.3	28.6
P/E avg. 90-94	21.2	49.8	14.3	28.7	13.0	13.5	14.8	27.1
<i>Financials^a</i>								
Pct. chg. Dec. 04-Oct. 05	-2.7%	31.9%	20.8%	22.3%	21.0%	18.8%	6.3%	13.2%
Pct. chg. Mar. 05-Oct. 05	0.4%	22.1%	12.6%	15.0%	14.1%	10.1%	4.5%	8.3%
P/E Oct. 05	13.5	33.7	13.9	12.0	13.1	19.2	13.0	16.4
P/E avg. Jan. 90-Oct. 05	15.4	63.2	15.8	19.2	12.4	20.4	16.7	13.6
P/E avg. 90-94	12.5	61.8	14.8	22.1	11.2	18.5	18.4	12.7
<i>Of which: Banks^a</i>								
Pct. chg. Dec. 04-Oct. 05	-8.3%	37.1%	19.4%	25.0%	16.6%	20.9%	2.5%	14.2%
Pct. chg. Mar. 05-Oct. 05	-4.7%	28.2%	11.5%	16.9%	12.5%	11.0%	2.9%	9.7%
P/E Oct. 05	12.6	35.9	14.2	14.5	11.1	17.7	11.8	17.0
P/E avg. Jan. 90-Oct. 05	14.3	97.7	13.3	13.7	10.7	16.2	14.2	12.9
P/E avg. 90-94	11.3	65.3	10.6	13.4	9.5	11.1	14.6	12.4
<i>Insurance companies^a</i>								
Pct. chg. Dec. 04-Oct. 05	1.0%	31.4%	18.7%	15.0%	33.0%	10.4%	21.1%	20.2%
Pct. chg. Mar. 05-Oct. 05	1.3%	19.7%	10.2%	9.9%	17.3%	5.1%	14.2%	13.1%
P/E Oct. 05	13.2	29.4	11.3	8.5	16.0	20.6	12.5	11.3
P/E avg. Jan. 90-Oct. 05	18.3	44.5	20.5	31.6	14.2	29.3	23.7	13.5
P/E avg. 90-94	14.0	48.9	24.5	47.4	11.4	33.5	29.2	12.2
<i>Life insurance companies^a</i>								
Pct. chg. Dec. 04-Oct. 05	17.0%	32.0%	14.8%	31.3%	4.1%	3.5%	6.6%	9.6%
Pct. chg. Mar. 05-Oct. 05	16.4%	14.4%	9.4%	18.7%	3.6%	0.3%	-1.6%	5.4%

Note: Calculations based on monthly averages (October 2005 data are until 10 October only). Earnings per share, the denominators of the price-earnings ratios, are based on the latest annualised rate reflecting the last financial year or derived from an aggregation of interim period earnings. For France, the current earnings per share are a forecast provided by local sources. For the United Kingdom, the earnings are calculated by a rolling 12 months method of analysis based on interim, final and annual accounts.

a) Datastream indices. The Insurance index includes non-life insurance companies, insurance brokers and other insurance companies; it does not include life insurance companies.

b) From Datastream Total Market indices.

Source: Thomson Financial Datastream.

*Uncertainties
around
the economic
outlook made
investors sensitive to
economic news,...*

the German DAX 30 showed the strongest performance, growing more than 16 per cent from March until early October. In comparison to Europe and Japan, equity markets in the United States showed weaker performance, even though the US economy has still been growing and is forecast to grow at a considerably faster pace than those in the former two countries.

Investors in the US have reacted to news which could change the picture of the health of the economy. In March and April, for example, negative economic news caused markets to drop. By contrast, the negative news on the US employment report released early in July caused major indices to spike upwards. The report undershot expectations and tamed fears of overheating which might have forced the Fed to adopt a more restrictive stance in the pace of its monetary tightening. By the same reasoning, higher-than-expected US non-farm payrolls released early in August, along with further oil price increases, heightened fears of a more advanced monetary tightening which could have put strains on the economy, and thus caused temporary drops in equity markets.

*... but broad
markets remained
resilient in the face
of terrorist attacks
and natural
catastrophes.*

Despite these uncertainties, markets in general remained resilient in the face of man-made or natural disasters. The terrorist attacks in London on 7 July caused a drop of the UK total market index of 1.4 per cent and a drop of the euro area total market index of 1.1 per cent, but this decline was ephemeral, as by 8 July these markets had regained their previous levels. The London attacks did not appear to have any effect on the US market, and, if at all, only a minor one on the Japanese market. Note in comparison that after the attacks in the United States on 11 September 2001, as well as after the bombings in Madrid in March 2004, markets in the affected countries took more than a month to recuperate their pre-disaster levels. Broad markets were also barely affected by hurricanes Katrina and Rita, which hit the United States Gulf Coast region at the end of August and in September, and where the former caused major human losses and a vast destruction of infrastructure. However, the increase in oil prices in the wake of these windstorms which destroyed oil fields and refineries in the Gulf of Mexico has weighed on markets more generally of late, and US markets have lost some of their earlier gains, even though early in October they are still above their mid-year levels.

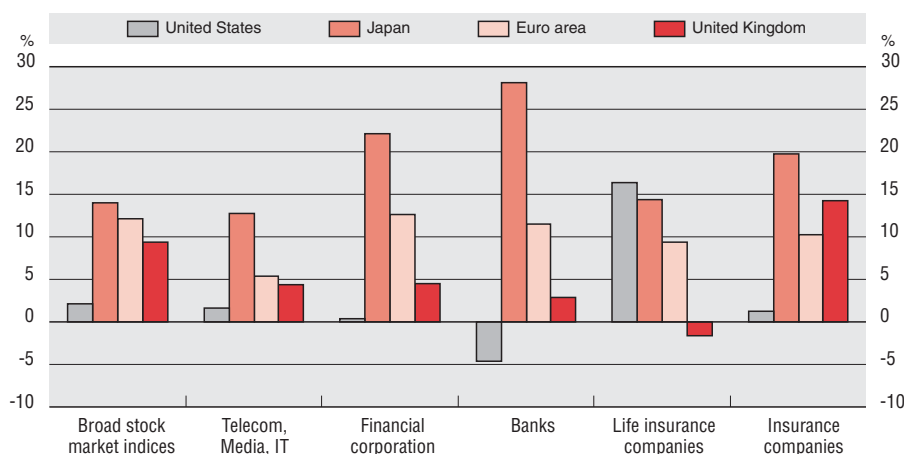
It is yet not clear how strongly these hurricanes will affect insurance companies' results. Reports by a big reinsurer in mid-September, doubling its estimates for the total insured loss from Hurricane Katrina and raising its provisional figures for the claims it would face, put further downward pressure on the sector's equity price index. But, as previous experience had shown, for some insurers the catastrophe brought the prospect of higher premiums which counterbalanced the downward trend of the sector's indices.

The performance of insurance sector stock market indices has been positive over the past few months, lagging the broader market by only a little in the United States and Europe. Banking indices in the United States significantly underperformed the broader market and other sectors. Under strain by rising interest rates and a flattening yield curve, US banks lost more than 8 per cent of their index value over the period from the end of last year until October, and almost 5 per cent since March (Table 1 and Figure 3). Japan again fared better than other major markets, with the financials sector outpacing the already strongly growing broad market index. In that segment, the banking

While the reinsurance sectors were hit by the recent catastrophes,...

... the insurance and financial sectors in general fared well, in Japan in particular, while banking indices underperformed in the United States.

Figure 3. **Recent sectoral stock market performance in major economies**
Percentage changes from March 2005 until October 2005



Note: Calculations based on monthly averages (October data are until 10 October only). Indices as specified in Table 1.
Source: Thomson Financial Datastream.

sector's good performance was driven by the successes of previous reforms which had strengthened banks' balance sheets. And in August, figures by the Bank of Japan showed that bank lending was up – the first rise dating back to 1998 when such data had been recorded for the first time –, fostering confidence in a positive turnaround of the Japanese economy.¹ Furthermore, the sector was boosted by prospects of the merger between the second largest Japanese Bank, Mitsubishi Tokyo Financial Group, and UFJ, the fourth largest Japanese bank, to create Mitsubishi UFJ as the biggest bank globally.

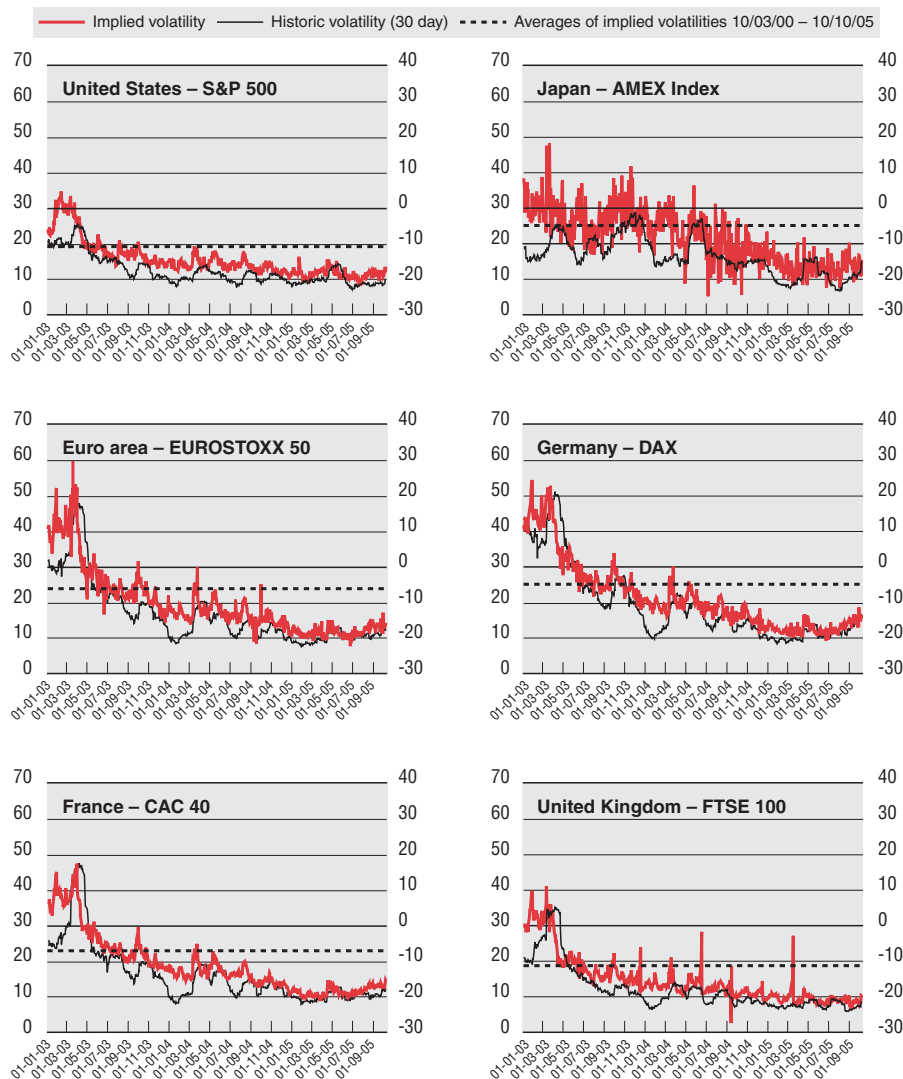
The life insurance sector showed strong growth as well, but the TMT's performance remained lacklustre.

The strongest gains among the Japanese financial sector sub-indices were recorded in the life insurance sector. Its index rose 32 per cent for the first three calendar quarters and over 14 per cent since March. The life insurance sector outperformed other indices as well in the US, rising almost 17 per cent from March until October, against an almost stagnant overall financials index over the same period. Life insurance also performed well in European Markets, growing almost 10 per cent from March until October. The telecom, media and IT (TMT) sector, which underperformed the broader markets across major economies, fared relatively better in Japan. In Europe, this sector performed well in France, but declined substantially in Italy, almost 3 per cent from March until October.

Overall, volatility remained low, and valuation far from speculative levels.

Over the past few months, volatility remained low or slightly declined further, staying below five-year averages in all major equity markets (Figure 4). This is true for both volatility measured as implied by options prices (implied volatility) and in terms of share price variations (historical volatility). The former, implicitly forward-looking measure was higher than the latter, historical measure from June or July onwards across all major markets. As well, price-earnings ratios (based on past earnings) have on average over the past few months been broadly in line with, and even below, their long-term averages, indicating that market valuation is far from speculative levels. In Japan, price-earnings ratios are still well below their long-run averages.

Figure 4. Stock markets: implied and historic volatilities



Note: Daily data until 10 October 2005. Historic volatilities are monthly volatilities calculated from daily data. Implied volatility can be interpreted as market expectation of risk (future volatility) and is derived from at-the-money call option prices (interpolated) using the Black-Scholes formula. The Cox-Rubinstein binomial method is used for American style options.

Source: Thomson Financial Datastream.

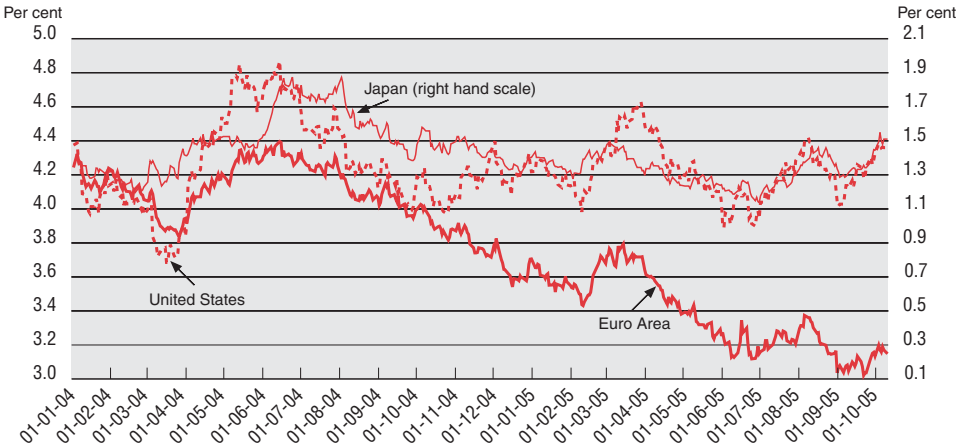
III. Bond markets and interest rates

*Long-term
benchmark yields
declined
substantially
in the euro area...
... and yield curves
have become flatter
in the United States
and the euro area,
but steepened
in Japan.*

As compared to a year ago, long-term government benchmark bond yields have declined slightly, on balance, in the United States and Japan, and more substantially, about one percentage point, in Europe, where they reached historical lows in September (Figure 5).

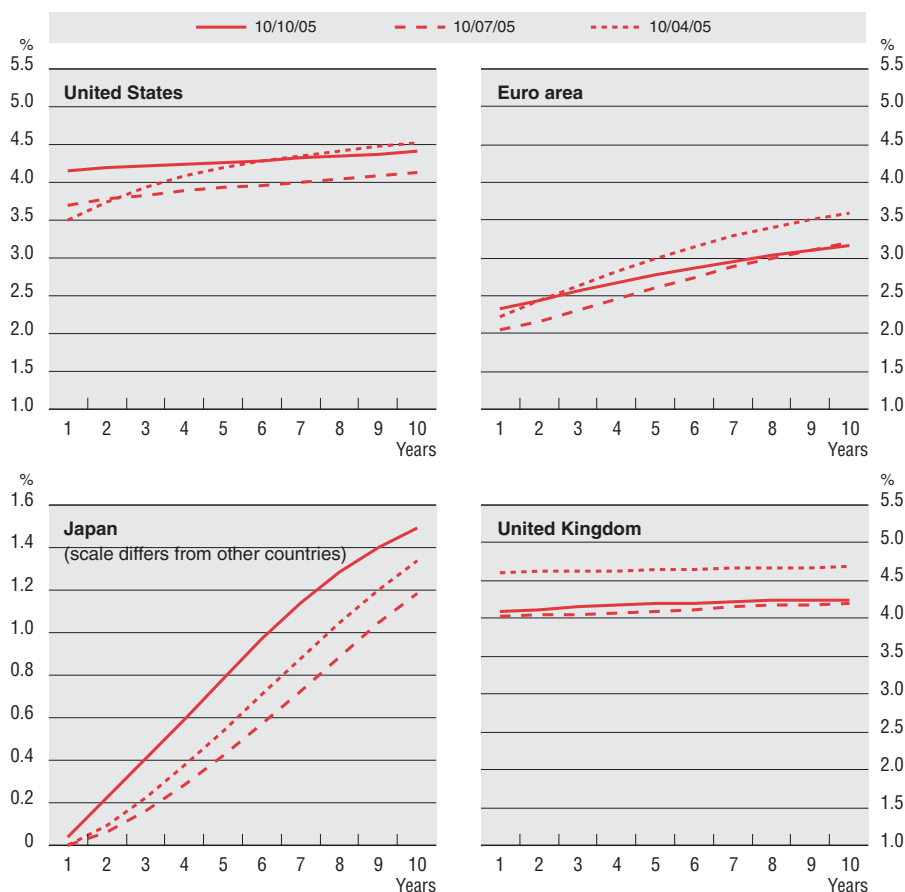
Along with the on-going monetary tightening, yield curves have become flatter in the United States (Figure 6). The Fed increased its target rate from 1 per cent to 3.75 per cent so far, in 11 steps since the end of June 2004 until 20 September 2005. In the euro area, with unchanged policy rates, the flattening of the yield curve came mainly through drops at the long end. In Japan, with short rates remaining at zero, rising long-term yields driven by the positive outlook on the economy led to a steepening of the yield curve. In the United Kingdom, the Bank of England counteracted an inversion of the yield curve and supported a weakening economy by lowering its policy rate to 4.5 per cent on 4 August, shifting a flat yield curve downwards. With a more vibrant economy, the Bank of Canada raised its policy rate on 7 September, from 2.5 to 2.75 per cent.

Figure 5. 10-year government benchmark bond yields



Note: Daily data until 10 October 2005.
Source: Thomson Financial Datastream.

Figure 6. Yield curves



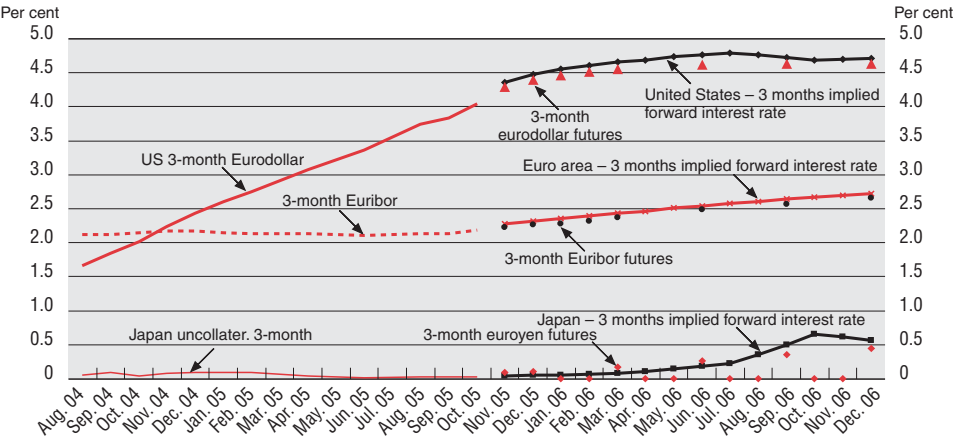
Note: Monthly averages of daily data.

Source: Thomson Financial Datastream.

Based on futures and forward rates implied by the shape of the yield curve, further monetary tightening is expected in the United States (Figure 7). In the immediate aftermath of the devastating hurricane Katrina there was uncertainty about a suspension of further Fed funds target increases, and by early September futures had dropped significantly. But these expectations quickly dissipated, with futures again attaining pre-disaster levels. In the euro area, according to futures and implied forward rates, investors

Investors have been expecting further policy rate increases by the Fed, and the ECB on hold.

Figure 7. **Implied forward and futures short-term interest rates**
United States, euro area and Japan



Note: Data as of 10 October 2005. Actual rates: United States: 3-months eurodollar middle rate; euro area: Euribor 3 month offered rate; Japan: uncollateral. 3-month middle rate; monthly averages. Implied forward rates are derived from zero-bond yield curves. Eurodollar futures: 3-month (CME); Euribor futures: 3-months (LIFFE), euroyen futures: 3-months (TIFFE).
Sources: Thomson Financial Datastream, OECD.

have been giving a very low probability to prospects for the ECB to raise its policy rates in the near future.

*Uncertainties
around
the economic
outlook made
US benchmark
yields fluctuate.*

In the United States, while fluctuating substantially, long-term benchmark bond yields maintained their year-to-date average levels, having reached about 4.4 per cent early in October. In between, yields had reached two lows, once at the beginning and again at the end of June. On the first of June, yields on ten-year US Treasury notes fell to their lowest level in more than a year, after a release of weak manufacturing data and suggestions that the Fed's rate rises would soon end. After some rebound, uncertainties about the Fed's policy led to a renewed decline in yields ahead of the FOMC meeting on 30 June. With the FOMC's decision to continue its monetary tightening, bond prices fell and yields climbed again. Later in August until early September, when oil prices rose to then record levels (which peaked at 67.5 USD for London Brent on 2 September), yields declined. When hurricane Katrina hit the New Orleans region and caused major devastation, fears of higher inflation were

probably strong driving forces behind rising yields. But with the concomitant increase in stock markets, this rise may also have reflected positive long-run growth expectations with the prospects of a positive impact from reconstruction work in the devastated region.

European benchmark yields followed a similar pattern; however, along a declining path. While they were at par with US benchmark yields in September 2004, the spread to US yields has now widened to more than 1 percentage point (about 120 basis points early in October). With inflation expectations in check, sluggish growth expectations have been one of the major driving forces behind these developments. For example, euro area government bond prices rallied and yields fell when the German Ifo business climate index released in late May fell to 92.9 from 93.3 in April, its fourth consecutive monthly decline, and the German ZEW survey of investor confidence came in worse than expected. Some speculation of an ECB rate cut at the end of May added further to a decline in yields. With the ECB's stance unchanged, low growth expectations supported the decline in yields. Shortly thereafter, however, yields were soon under upward pressure brought on by rising oil prices, which fuelled fears of inflation and drove up yields through early August, before they fell again to new record lows in the second half of September. More recently, euro area yields have recovered somewhat to around 3.2 per cent early in October.

Euro area benchmark yields have been on a downward trend,...

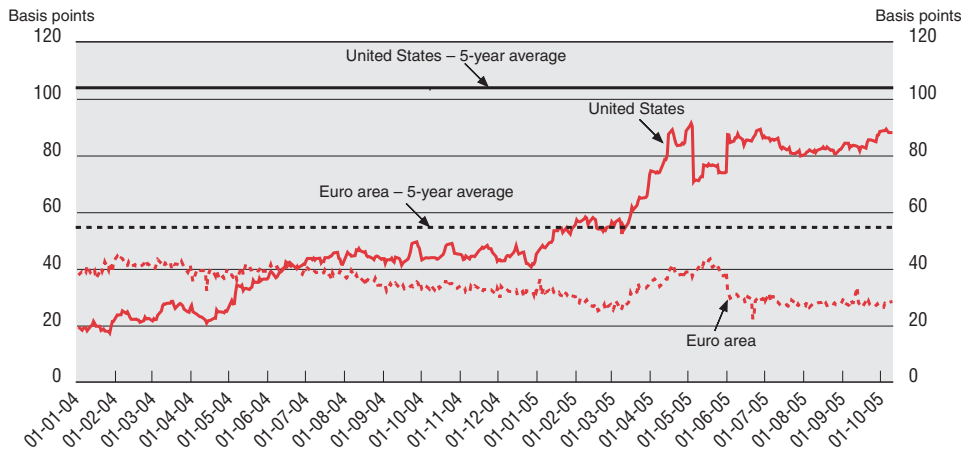
In Japan, positive expectations about the economic outlook, which were also reflected in equity markets, supported an upward trend in bond yields beginning at the end of June. A slight decline which set in around the second half of August also reflected investors' caution before the General Election which took place on 11 September. Since then, yields have risen again and have early in October regained their peaks of August and from earlier in the year.

... and benchmark yields rose in Japan.

Corporate spreads are still below long-run averages in the United States as well as in Europe (Figure 8), but have been rising significantly in the United States, partly due to supply factors (see below). Investment-grade spreads, *i.e.* spreads between BAA and benchmark yields, have risen

Corporate spreads are still low...

Figure 8. Investment-grade corporate bond spreads



Note: Daily data until 10 October 2005. Aggregate corporate BAA bond yields (Lehman indices) minus 10-year government benchmark bond yields for the United States; and JP Morgan Maggie government spread of investment grade credit, all sectors, all maturities, for the euro area.

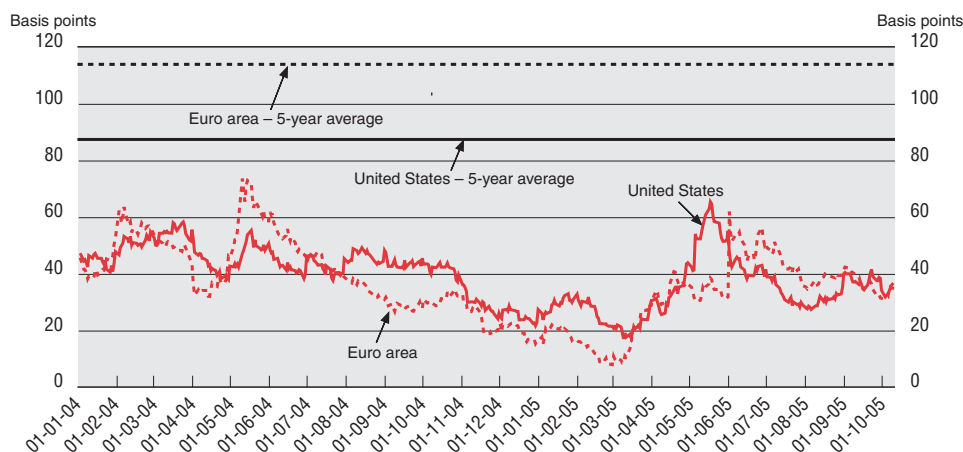
Source: Thomson Financial Datastream, OECD.

about 50 basis points since the beginning of the year in the United States, while in Europe they have moved mainly sideways, except for a slight increase in the second quarter, when further weaknesses of the euro area economy became apparent and depressed benchmark bond yields. This increase in spreads culminated in a drop of more than 10 basis points by early June. Spreads between high-yield and BAA bonds' yields also remained well below their long-run averages, despite rising somewhat in both economies (Figure 9). By mid-May and early-June, high yield spreads on both sides of the Atlantic had increased about 170 basis points from their lows earlier this year. Since then, they have again declined, by about 100 basis points as of early October.

*... reflecting
investors
confidence,...*

The low credit spreads (investment-grade as well as high-yield) reflected, in part, the overall positive sentiment. Strong economic growth in general and corporate earnings growth in particular helped to strengthen investors' confidence in the quality of credit. Moreover, corporate default rates were forecast to remain low for some time before picking up during 2006. Upgrades have been higher than

Figure 9. High-yield bond spreads



Note: Daily data until 10 October 2005. Aggregate corporate high-yield bond yields minus aggregate corporate BAA bond yields (Lehman indices) for the United States; JP Morgan Maggie government spread of high yield credit, all sectors, all maturities, for euro area.

Source: Thomson Financial Datastream.

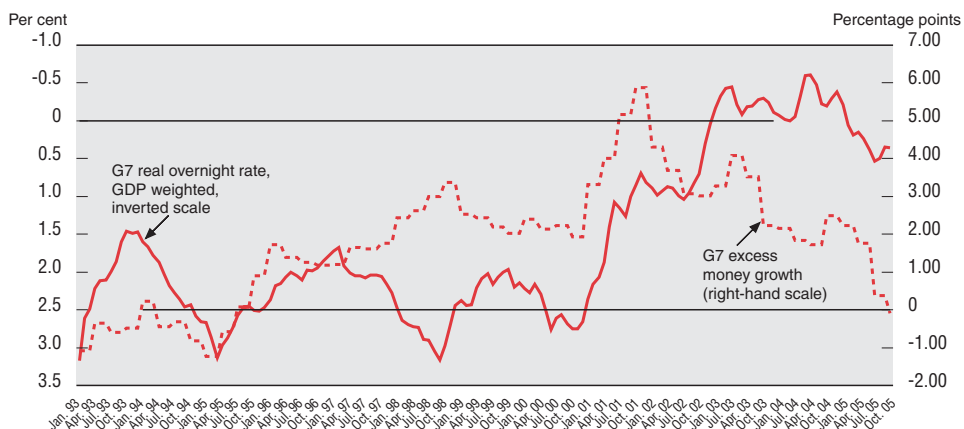
downgrades in the United States, even though there are indications that this measure will further decline from its peak earlier this year. The downgrades in the US automobile sector early in May² which had led to a debt sell-off, seemed not to have had longer lasting effects, and by June the sector began to tap the unsecured market again.

Liquidity conditions, which continued to show some contraction along with the tightening stance of the Fed, have nonetheless remained accommodative (Figure 10) and have thus further contributed to keeping spreads tight and helping to averting corporate defaults. Relatively ample liquidity is also reflected by the easing of lending conditions, especially in the United States as reported in the *Federal Reserve Loan Officer Opinion Survey on Bank Lending Practices*. Similar results come from the *Euro Area Bank Lending Survey* conducted by the European Central Bank, which also showed a more pronounced increase in the net percentage of banks reporting easing credit standards in July.

... but also ample liquidity.

Figure 10. Proxies for global liquidity developments

G7 real overnight rate, GDP weighted, inverted scale, and actual money growth minus potential real GDP growth, in percentage points



Note: The global liquidity indicator based on real interest rate developments follows C. Borio and W. White (2004), "Whither monetary and financial stability? The implications of evolving policy regimes", BIS Working Paper No 147. The measure shows a weighted average of real overnight rates in G7 countries; for France and Germany, the Euro Overnight Index Average (EONIA) is used from 1999 onwards. The weights are based on USD GDP, and real rates are calculated by deducting three-month moving averages of year-on-year CPI changes from nominal overnight rates, including projected CPI changes in cases where most recent data have not yet been available. The other indicator focuses on G7 excess money growth (again as GDP-weighted average). Actual nominal money growth is the year-on-year growth of quarterly broad monetary aggregates; potential real GDP growth is corrected for trend velocity growth, i.e. it is a residual money growth measure derived from the quantity equation assuming zero inflation. Trend velocity growth is based on average velocity growth 1980-2002 in the respective economies, except for the euro area, where it is based on the mid-value of the range for velocity growth as assumed by the European Central Bank in deriving the quantitative reference value for monetary growth (0.75).

Source: Thomson Financial Datastream; OECD, Main Economic Indicators and Economic Outlook database; European Central Bank.

***Yields have also
been kept low
by structural
demand factors.***

In addition to these factors, there is also a long-term structural increase in demand for bonds which is helping to keep rates low. Increased saving for retirement in ageing societies, in particular through pension funds, and demand from Asian economies, mostly through foreign exchange interventions by their central banks in order to keep the value of their currencies down, have added to the downward pressure on yields. And, according to a recent study, this global "saving glut"³ is to a big extent driven by increased global corporate savings.⁴ According to this research, companies have hoarded in excess of USD 1 trillion during the past four years, after they had gone on a spending spree in the late 1990s. This is a shift five times larger than the USD 200 billion plus change in emerging market savings between 2001 and 2005.

Looking at supply factors on bond markets, net issuance of government bonds in the United States, which had been on a downward trend since the beginning of 2004, turned negative in the second quarter (Figure 11). Apart from the demand factors discussed above, this drop in supply helped bid up treasury prices and showed up as downward pressure on yields. Over the second quarter, US 10-year benchmark yields fell around 60 basis points. As well, this supply contraction has partly been responsible for the increases in corporate spreads.

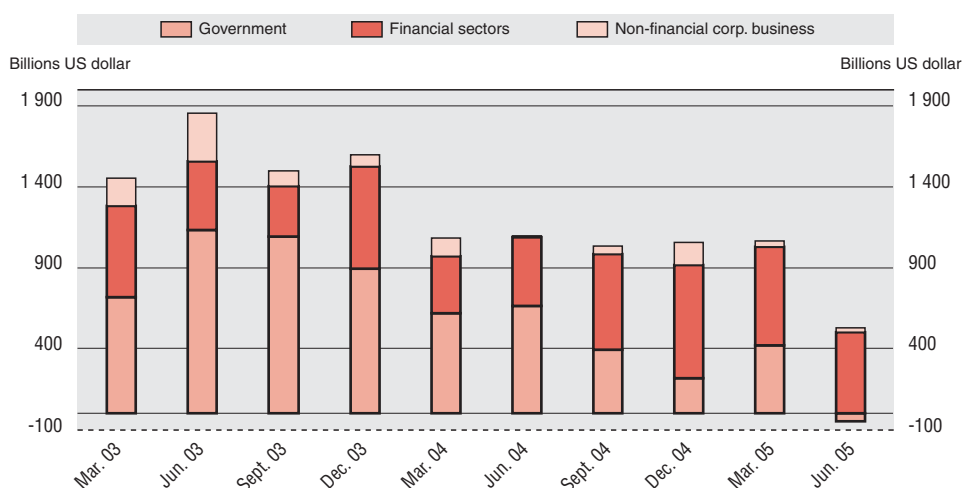
For corporate bonds, however, supply factors had somewhat less weight. While net issuance of non-financial corporations declined on average for the first half of 2005 as compared to averages of the years before, they held up relatively well. And so did the financial sector which has in the three previous quarters issued the lion's share of US bonds. In the euro-denominated bond markets, issuance remained strong (Figure 12), even disregarding a surge of financial sector issuance in June which has to be ascribed to special factors.⁵ The advanced issuance in June likely accounts for the decline in issuance in the succeeding months.

A drop in US treasury supply weighed on yields ...

...but issuance held up elsewhere.

Figure 11. **Net issuance of US bonds**

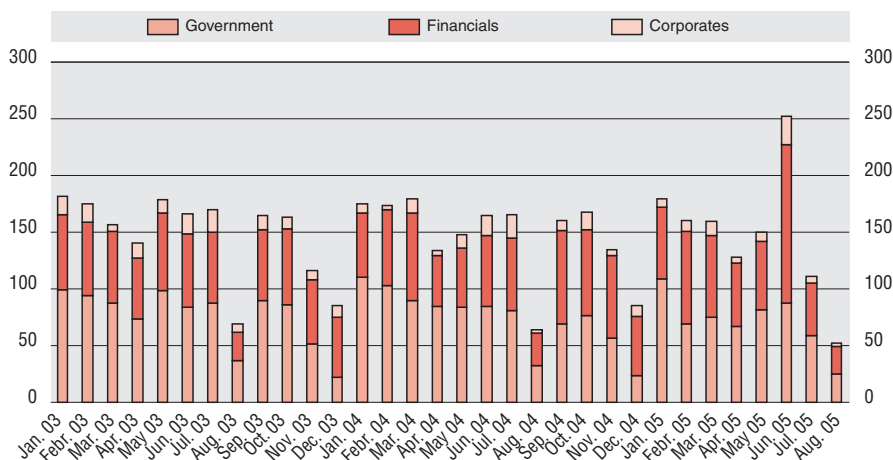
In billions of US dollars, quarterly, seasonally adjusted, at annual rates



Note: Government includes Treasury, Municipal and Agency Securities.

Source: US Federal Reserve Board, Flow of Funds Accounts of the United States.

Figure 12. **Euro-denominated bond markets: volumes issued by type of issuer**
In billions of euros



Note: Issues of a maturity of one year or more. "Government" comprises bonds of agencies, central governments, municipalities, regions, cities, and supra-nationals. "Financial" comprises asset-backed securities, financials' bonds, and Pfandbriefe. The latter includes Pfandbrief-style paper issued in EU-countries, like for instance French Obligations foncières, Spanish Cédulas hipotecarias, etc. Note that, according to information from the European Commission, the surge in issuance by financial institutions and by non-financial corporations in June 2005 seems to be mainly related to the implementation deadline of 1 July 2005 for the new EU Directive on prospectuses, which will require most companies to update their borrowing programmes before returning to the market.

Source: European Commission (DG ECFIN).

More long-term instruments entered the market, meeting institutional investors' demand.

In meeting increased demand from institutional investors, in particular from pension funds and insurers which need to match their ever lengthening liabilities, governments have further raised their issuance of ultra-long bonds. Already in 2004, the US Treasury had issued 20-year inflation-protected securities (TIPS), and has recently announced plans to reintroduce a 30-year bond at the beginning of 2006. The issuance of the long bond had been discontinued in 2001 in the face of budget surpluses. Also in 2004, the Italian government successfully placed 30-year index-linked bonds, additional amounts of which were offered this year. In February, the French Treasury issued a 50-year bond. In May, the UK government re-introduced a 50-year gilt into the market after a break of more than four decades. This issue was followed by another auction in July. In September, the UK Treasury issued the world's first 50-year inflation-linked bond. The bond was sold through a syndicate of

banks. As the offer drew more than GBP 2 billion in demand, the offer size of GBP 1 billion was increased to GBP 1.25 billion. Moreover, the bond offered a real yield of only 1.112 per cent, the lowest ever on an inflation-linked bond, and 19 basis points below the 30-year inflation linker.

Elsewhere, the credit derivatives market grew strongly this year as banks, hedge funds and others have substantially increased their use of complex financial instruments, according to a recent survey by the International Swaps and Derivatives Association.⁶ In June, the total notional value of all outstanding credit derivatives contracts reached USD 12.43 trillion, a 48 per cent increase from January and a 128 per cent rise compared with a year earlier. The growth of this market segment highlights the changes under way in the global financial system as banks and investors use these instruments to manage risks. While these instruments offer benefits as risk management tools, they also pose challenges. Because trading occurs over-the-counter in private deals rather than on exchanges, the sector is very opaque and difficult to monitor. The rapid growth has also strained the trading infrastructure of banks and hedge funds which have a large backlog of back office processing.

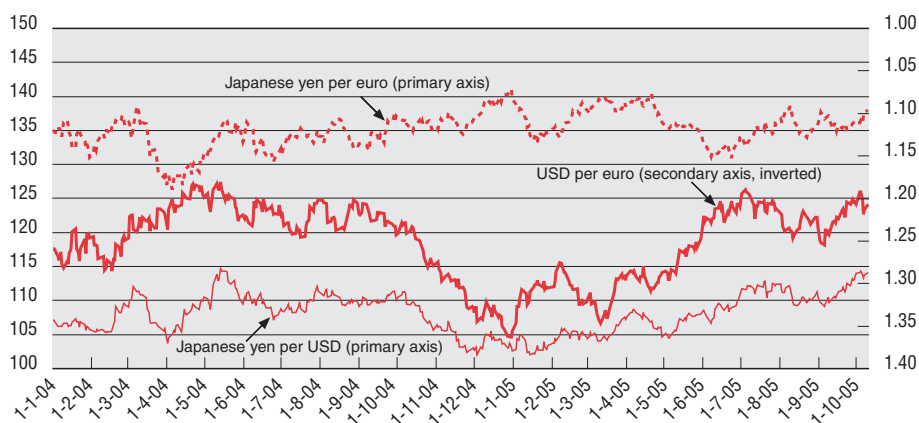
Credit derivatives soared as investors tried to shift risks, posing further challenges to policy makers.

IV. Foreign exchange markets

Since mid-March until mid-July, the US dollar has been on an upward trend against the Euro and, somewhat more pronounced, against the yen, which in turn appreciated slightly against the euro until mid June (Figure 13). The subsequent weakening of the yen against the US dollar and the euro mirrored weak economic data (*e.g.* a fall in industrial production of 2.3 per cent between April and May) which investors interpreted as signs that a recovery of Japanese growth was still tentative. In mid August, uncertainties around the General Elections scheduled for mid September again put downward pressure on the yen. At the end of August and early September, the dollar sharply dropped in the aftermath of the Katrina disaster, beyond 125 cents to the Euro, but soon it continued its upward trend to around 120 cents per euro early in October.

The US dollar strengthened against the euro and the yen,...

Figure 13. Major exchange rates



Note: Daily data until 10 October 2005.

Source: Thomson Financial Datastream.

*... unexpectedly for
some,...*

According to some market analysts, this unexpected strength of the US dollar may have had negative effects for pension funds, trend-following hedge funds and private investors which had made bets on a declining dollar. The activity in exchange-traded derivatives, as investors were apparently increasingly trading dollar risks, rose 15 per cent to USD 3 trillion in the second quarter.⁷ Elsewhere, overseas profits of US corporations have been flattening or falling as the dollar reversed the declining path it had been on throughout the second half of last year. The depreciation of the US dollar had made the earnings of US affiliates abroad an important source of profit for multinational companies.

*... but it has been
reflecting interest
and growth
differentials...*

For many investors the still high US current account deficit along with increased fiscal spending had hinted at further downward adjustment of the dollar. But more immediate structural factors have been supporting the dollar's recent upswing, such as a widening interest rate differential between US and euro area long-term bonds, reflecting deteriorating growth expectations for the euro area, and continued strong demand for US assets.

Indeed, net capital inflows into the United States remained strong (Figure 14). While inflows from Japan have somewhat weakened over the past few months, demand from other Asian countries, in particular from China, increased. In June and July, China's net purchases of US securities amounted to USD 14.7 billion and USD 13.8 billion, respectively, close to their record of USD 16.9 billion in February. Again, most of the total inflows were invested in Treasuries, although corporate bonds surged in June, accounting for over 60 per cent of all net inflows in bonds (Figure 15). With strong US equity investments abroad meeting a likewise high foreign demand for US equities, net inflows in equities were roughly in balance. On a monthly average basis, foreigners invested USD 350 billion in US equity in the January to July 2005 period, up from USD 330 billion in 2004.⁸

... and continued appetite for US assets, in particular from Asian economies,...

Japan still holds the major share, about one third, of all US assets abroad, while over 20 per cent are held by other Asian countries, more than half of which is by China. And, while OPEC countries have a share of only about three per cent of US assets held by foreigners, it is interesting to note that over the last year, with the surge in oil prices, oil exporters have invested part of their windfalls in US assets (Figure 16). While they have diversified their exposure and moved somewhat out of dollar assets over the past few months, in July they still held USD 53 billion in US assets, more than in June 2004.

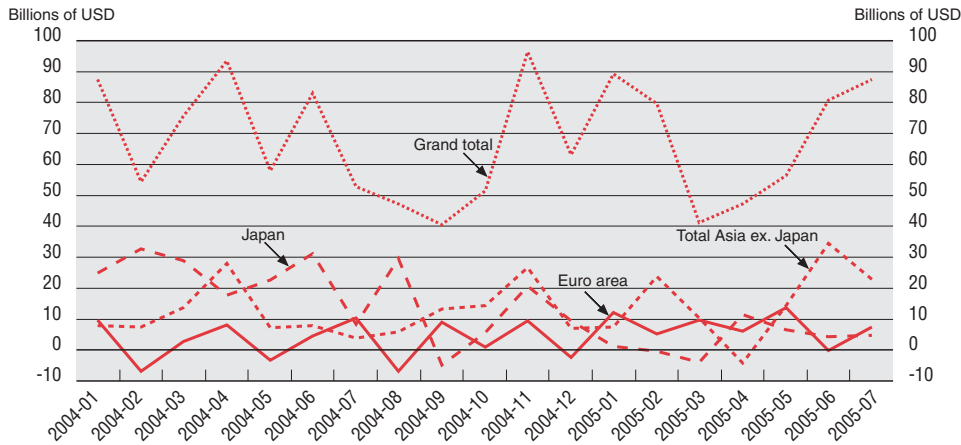
... and, albeit on a smaller scale, OPEC countries.

V. Emerging markets

Growth in emerging markets has continued to attract foreign investors, and while the pace is expected to weaken somewhat as compared to the previous year, GDP growth in emerging economies remains well above OECD growth and higher than world growth.⁹ The positive sentiment has been reflected in a further compression of yield spreads of emerging market bond indices (EMBI) over US government paper, which reached new historical lows in early October (Figure 17). This spread compression may be driven in part by positive growth differentials of emerging markets *vis-à-vis* industrial economies.

Record lows of EMBI spreads have reflected, in part, a positive outlook for emerging economies.

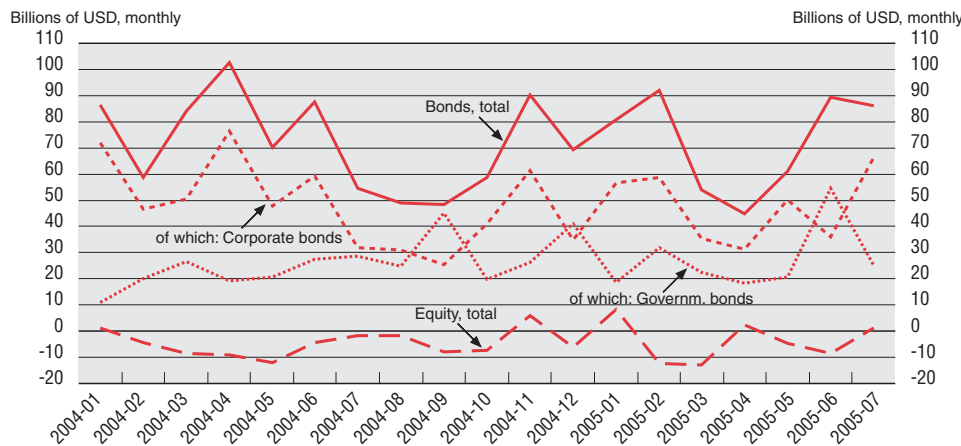
Figure 14. Net portfolio flows into US by region
Billions of US dollars



Note: Net portfolio flows are net purchases of assets by foreigners from US Residents (gross purchases – gross sales).

Source: US Treasury, Treasury International Capital (TIC) Reporting System.

Figure 15. Net portfolio flows into US by category
Billions of US dollars

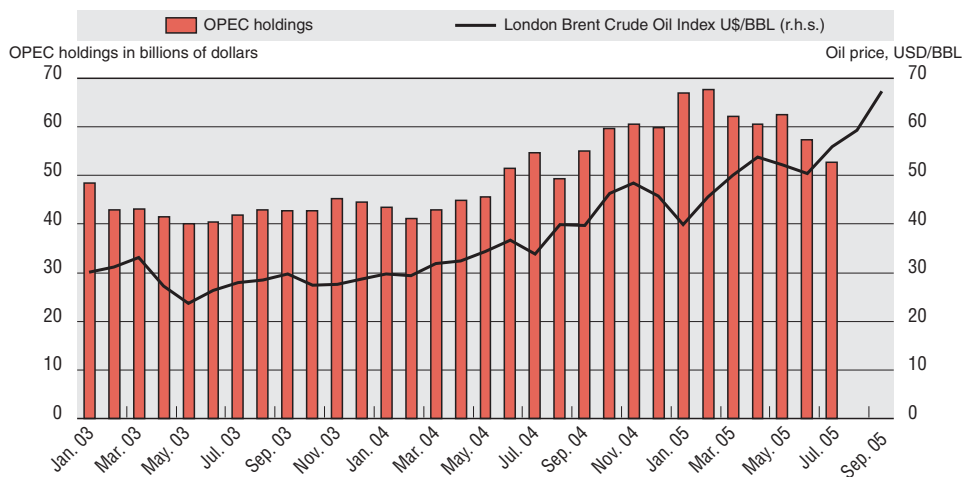


Note: Net portfolio flows are net purchases of assets by foreigners from US Residents (gross purchases – gross sales). Bonds comprise US and foreign bonds; government and corporate bonds as shown here are US bonds only; equity comprises US and foreign equity.

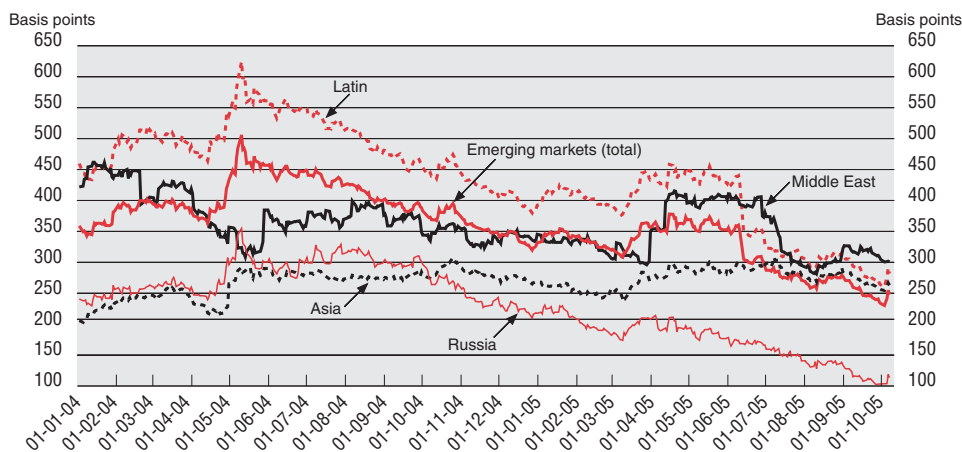
Source: US Treasury, Treasury International Capital (TIC) Reporting System.

Figure 16. **OPEC holdings of US assets**

Total holdings of US assets by residents of OPEC countries, in billions of US dollars, and oil price in USD/BBL, monthly averages



Source: US Treasury, Treasury International Capital (TIC) Reporting System; Thomson Financial Datastream.

Figure 17. **Emerging market bond spreads**

Note: Daily data until 10 October 2005. JP Morgan EMBI Global blended spreads over US benchmark bond yields. EMBI Global covers US dollar denominated Brady Bonds, Eurobonds, Traded Bonds and local market debt instruments issued by sovereign and quasi-sovereign entities.

Note also that, according to information from JP Morgan, the strong drop from 10 to 13 June 2005 in the Latin American and, consequently, in the emerging markets total index is due to an intra-month rebalancing triggered by the Argentina debt exchange. As a result of the rebalancing, Argentina defaulted debt (with spreads of 5000 b.p. and above) was partially replaced with performing debt with much lower spreads.

Source: Thomson Financial Datastream.

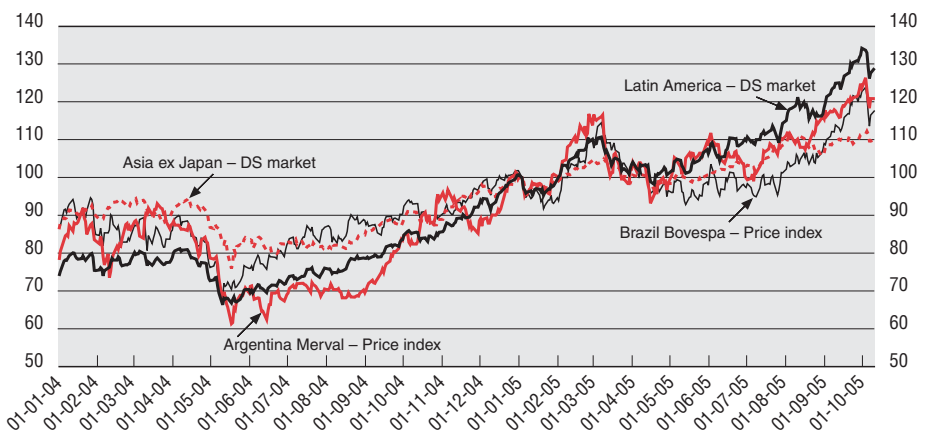
Increased emerging market debt issuance has been meeting demand.

Emerging market debt has been continuously upgraded. More than half of the JP Morgan EMBI Global index is now investment grade, compared with about 10 per cent in 1998. In the search for yield, many institutional investors have increased their exposure to emerging markets.¹⁰ In response to increased demand, emerging market debtors increased their issuance to a record amount during the first seven months of 2005, 22 per cent above the issuance volume over the same period of the previous year.¹¹ Recently, taking advantage of lower financing costs while being confident about a stable macroeconomic environment, many issuers – Latin American governments in particular – have placed their debt in major foreign currencies, mostly in US dollars.

Emerging stock markets have been buoyant, in particular in Brazil...

Driven by demand from foreign investors' as well as domestic demand, stock markets of major emerging regions have rebounded (Figure 18). The rebound was particularly pronounced in Latin America. However, it came only after a somewhat weaker performance in the second quarter. In Brazil, political uncertainty related to accusations of corruption in the government led to an increase in Brazilian bond spreads in late July and again in late August. Nonetheless,

Figure 18. **Stock market performance in selected emerging economies**
Equity price indices, 3 Jan. 05 = 100



Note: Daily data until 10 October 2005.
Source: Thomson Financial Datastream.

among the large countries of the region, Brazil's stock market has been one of the best performers recently, and in dollar terms, due to the strengthening real, has outperformed others by far.

In Argentina, investors gained renewed confidence after a successful debt restructuring and backed by a 7.5 per cent growth forecast for this year, which is more than double the growth of the Brazilian economy. The Argentine debt restructuring was initiated in February, and investors were offered about USD 35 billion of new securities for USD 100 billion of old debt and interest payments on the latter of more than USD 600 million. With 76 per cent participation, the result of the debt restructuring was a decline of the debt burden to 72 per cent of GDP (which was at 147 percent of GDP in 2002 after the country's record debt default in December 2001), along with a considerable improvement in the debt service profile. At the beginning of June, Standard and Poor's upgraded Argentina's long-term debt rating to a B- with a stable outlook, up from selective default (SD), sending a positive signal to investors who had remained cautious after the country's record debt default in December 2001.

*... and,
with successful debt
restructuring,
in Argentina.*

While Asian bond yield spreads have stayed above the total emerging market index yields since last August, they have declined in concert with other emerging market spreads. On 21 July, China revalued the renminbi by 2.1 per cent, at the same time introducing a managed float against the dollar of 0.3 per cent per day. Later it announced a non-dollar band of 1.5 per cent daily. In order to reduce its need of intervention on multiple currency markets, China's central bank announced on 23 September a further widening of the band of the renminbi, now permitting trading against non-dollar currencies within a band of 3 per cent per day.

*Pressure
from continued
high growth
in Asia's powerhouse
China have led
to more policy
flexibility regarding
the renminbi.*

Notes

1. After adjusting for special factors such as bad-loan write-offs, currency fluctuations and securitisations, the Bank of Japan figures showed August lending 0.2 per cent higher than a year before, at JPY 386,990 billion.
2. On 5 May 2005 Standard and Poor's downgraded the debt ratings of US automakers General Motors Corp. and Ford Motor Co. below investment grade, and Moody's Investors Service followed suit on August 25, by downgrading both auto producers to junk status.
3. The term was coined in Remarks by Governor Ben S. Bernanke, *The Global Saving Glut and the US. Current Account Deficit*, at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, on 10 March 2005.
4. See JPMorgan Research (2005), *Corporates are driving the global saving glut*, J.P. Morgan Securities Ltd, June 24.
5. According to information from the European Commission, the surge in issuance by financial institutions and by non-financial corporations in June 2005 seems to be mainly related to the implementation deadline of 1 July 2005 for the new EU Directive on prospectuses, which will require most companies to update their borrowing programmes before returning to the market.
6. ISDA – International Swaps and Derivatives Association, Inc. (2005), *ISDA Mid-Year 2005 Market Survey*, New York, ISDA (also available at www.isda.org). The ISDA survey covers both credit default swaps and synthetic collateralised debt obligations.
7. Bank for International Settlements, *BIS Quarterly Review*, September 2005.
8. Total inflows into the United States in equity, which consist of foreign purchases of US stocks as well as sales of foreign equity held by US residents, amounted to USD 512 billion for the January-July 2005 period, and to USD 469 billion in 2004 (monthly averages). In comparison, total inflows in bonds amounted to USD 1 183 billion for the January-July 2005 period, and to USD 1 065 billion in 2004 (monthly averages).
9. According to the recent IMF *World Economic Outlook* (September 2005), GDP growth for the group of emerging market countries was slightly revised upwards to 6.4 per cent in 2005 and 6.1 per cent in 2006, above world growth of 4.3 per cent in 2005 and 2006, and growth of industrialised countries of 2.5 per cent in 2005 and 2.7 in 2006. The current OECD *Economic Outlook* (June 2005) estimates GDP growth for the total of OECD countries at 2.6 per cent in 2005 and 2.8 per cent in 2006.
10. One example is the California Public Employees' Retirement System (CalPERS), the largest US public pension fund with assets totaling USD 182 billion; see *CalPERS Adopts Emerging Market Debt Investment Policy*, Press release, 15 June 2005, available at www.calpers.ca.gov.
11. Bank for International Settlements, *BIS Quarterly Review*, September 2005.

L'actualité récente des marchés des capitaux

I. Vue d'ensemble

Ces derniers mois, les cours sur les principaux marchés de capitaux sont restés élevés malgré la poursuite du renchérissement du pétrole. Après avoir connu un trou d'air vers mars et avril, les principaux marchés d'actions ont repris leur ascension au deuxième trimestre. Les attentats terroristes de juillet à Londres, puis l'ouragan Katrina aux États-Unis, qui a frappé la région de la Nouvelle-Orléans fin août, n'ont pas fait vaciller les marchés, malgré l'ampleur des pertes humaines, économiques et des sinistres assurés.

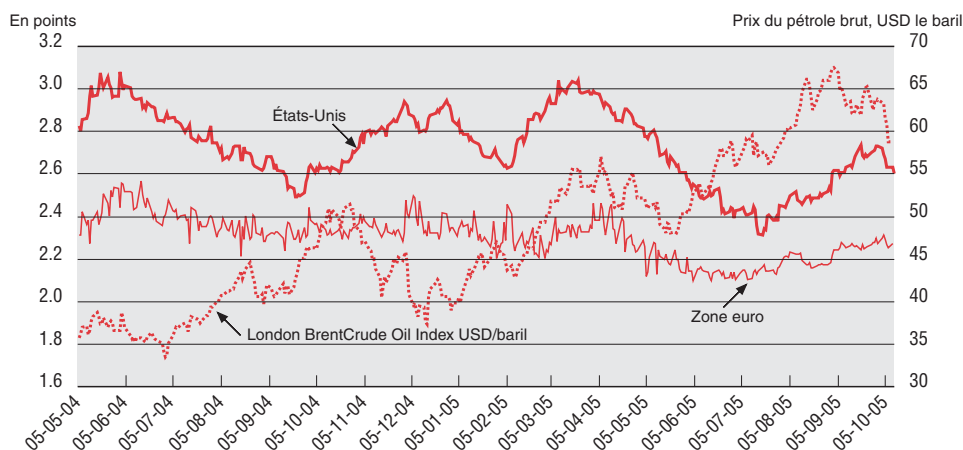
*Les cours
sont restés élevés.*

Les rendements obligataires sont restés faibles. Les taux des obligations de référence à long terme aux États-Unis ont certes connu des fluctuations, mais ils sont généralement restés stables en moyenne depuis le début de l'année, tandis que les rendements dans la zone euro ont encore baissé jusqu'à des niveaux historiquement bas en septembre.

*Faiblesse
des rendements
obligataires
aux États-Unis
et nouveau recul
dans la zone euro.*

Parallèlement, les écarts de rémunération ont récemment connu une légère détente par rapport à leur niveau très comprimé ; ils n'en demeurent pas moins inférieurs à leur moyenne rétrospective. Même si les incertitudes entourant les perspectives imputables à la hausse des prix des matières premières et aux ajustements possibles des déséquilibres mondiaux ne se sont pas entièrement dissipées, la volatilité est restée modérée dans la plupart des segments du marché.

*Des écarts
de rémunération
toujours inférieurs
à leur moyenne
rétrospective.*

Graphique I. **Anticipations sur l'évolution de l'inflation implicite et du prix du pétrole brut**

Note : Données quotidiennes jusqu'au 14 février 2005. Les anticipations d'inflation implicite (« point mort d'inflation ») sont égales aux écarts de rendement entre les obligations d'État de référence à 10 ans et les obligations indexées sur l'inflation (indices des obligations d'État indexées sur l'inflation calculés par Merrill Lynch).

Source : Thomson Financial Datastream.

**Malgré
de nouvelles
mesures
de resserrement
aux États-Unis
une liquidité
mondiale encore
relativement
abondante.**

Le Comité de politique monétaire de la Réserve fédérale américaine a continué son cycle de resserrement en relevant ses taux directeurs. Si l'on y ajoute les déclarations « va-t-en-guerre » de certains représentants de la Fed, ces mesures ont eu pour effet de stimuler les anticipations d'une poursuite du resserrement que traduisait implicitement l'évolution des taux à terme. La hausse du dollar a un peu assoupli les conditions monétaires dans la zone euro, où la BCE n'a pas modifié ses taux directeurs. La liquidité mondiale, tout en diminuant légèrement, reste très généreuse, ce qui favorise toujours « la quête de rendement » sur les marchés de capitaux.

**Confirmation
du dynamisme des
marchés émergents
et de la faiblesse
des écarts de
rémunération des
indices obligataires
correspondants**

Ces derniers mois, les actions des marchés émergents se sont de nouveau mieux comportées que celles des grandes économies de l'OCDE. L'abondance relative de la liquidité mondiale et la quête de rendement qui l'accompagne, ainsi que les anticipations de croissance vigoureuses concernant la plupart des marchés émergents se sont traduites par un resserrement supplémentaire des écarts de rémunération des obligations de ces marchés,

parfois jusqu'à des niveaux d'une faiblesse sans précédent. En juillet, la Chine a introduit plus de flexibilité dans son dispositif de change en remplaçant sa parité fixe par rapport au dollar par un régime de flottement administré reposant sur un panier de monnaies.

II. Marchés d'actions

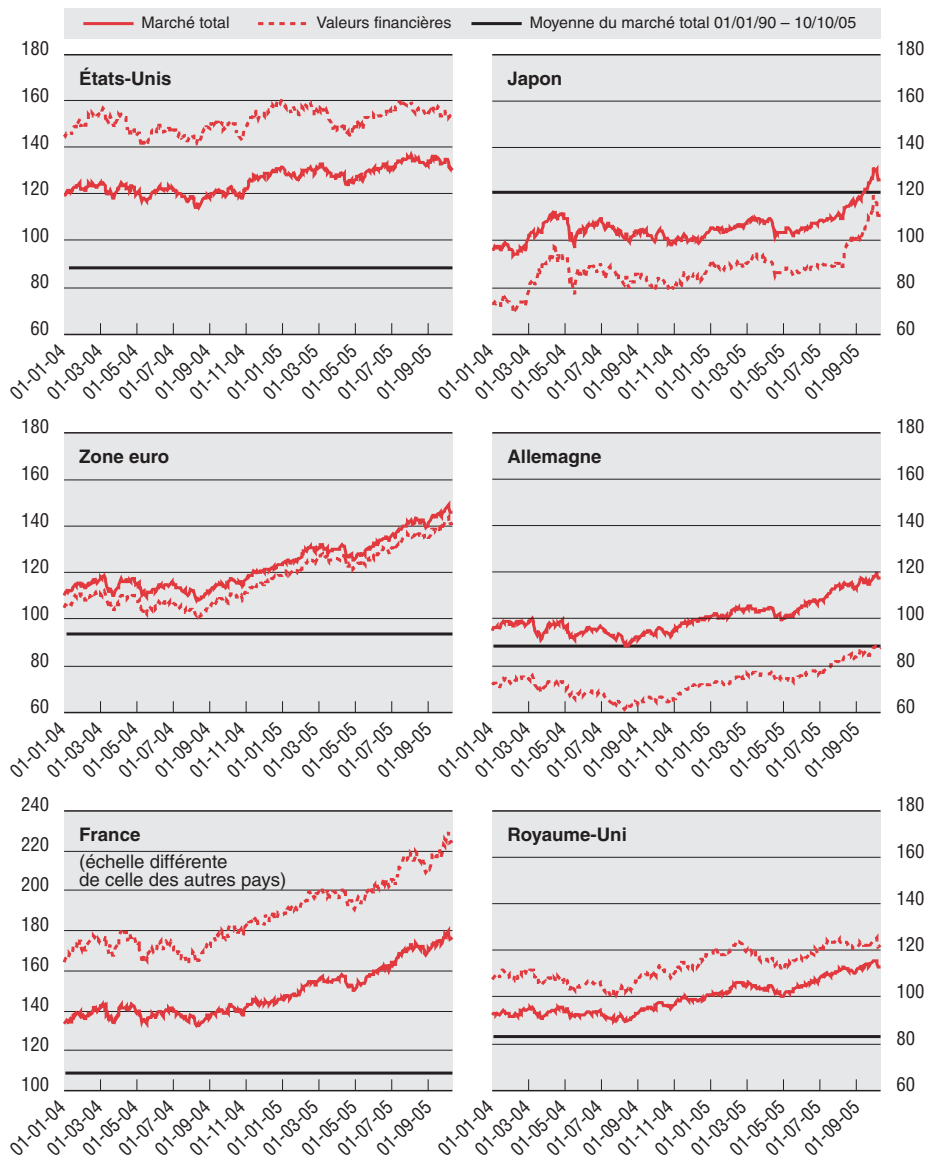
Ces derniers mois, les marchés d'actions des grandes économies ont affiché de belles performances, ce qui traduit des perspectives généralement positives et une confiance non démentie des investisseurs dans la capacité des économies à absorber le renchérissement des matières premières (graphique 1) et les ajustements des déséquilibres mondiaux (graphique 2). Un peu plus tôt dans l'année, cependant, ces deux facteurs potentiels de baisse ainsi que des statistiques économiques médiocres ont pesé sur les marchés en mars et avril et jusqu'au début du mois de mai en Europe. Ces statistiques faisaient alors craindre un ralentissement de la croissance aux États-Unis, tandis que la persistance de l'inflation alimentait les pronostics selon lesquels un resserrement progressif des conditions monétaires par la Réserve fédérale allait freiner encore la croissance. Parallèlement, diverses indications d'une diminution des bénéfices de certaines sociétés multinationales venaient encore assombrir un tableau peu optimiste et ce, bien que les bénéfices publiés soient restés eux-mêmes positifs.

En fin de compte, ce sont ces bénéfices qui ont constitué la base du rebond qui s'est déclenché vers la mi-avril pour le marché américain et en mai pour les actions européennes. Sur les deux marchés, les bénéfices des entreprises ont augmenté de plus de 10 % en glissement annuel au second trimestre et même si cette progression a été inférieure à la croissance de l'année précédente, elle aura dépassé les attentes des investisseurs. Ces évolutions ont en outre été confortées par d'autres nouvelles positives, comme la hausse des ventes au détail et l'augmentation des créations d'emplois qui ont donné un coup de pouce supplémentaire à la confiance des entreprises et des consommateurs.

*Belles performances
des marchés
d'actions
des principales
économies...*

*... soutenues
par les bénéfices
des entreprises
et de bonnes
nouvelles
économiques...*

Graphique 2. **Principaux marchés d'actions**
Indices du marché total et des valeurs du secteur financier,
base 100 au 1^{er} janvier 1998 = 100



Note : Indices Datastream indices. Données quotidiennes jusqu'au 10 octobre 2005.
Source : Thomson Financial Datastream.

Parmi les principales places financières, c'est le marché japonais qui a affiché les meilleures performances, les perspectives positives de croissance économique ayant suscité de fortes entrées de capitaux étrangers qui ont stimulé la hausse du marché japonais d'actions. Les prévisions moyennes des économistes du secteur privé concernant le PIB japonais pour 2005 ont été continuellement révisées à la hausse, de 1 % d'après l'enquête de mai à près de 2 % lors de celle de septembre. Les non-résidents ont généralement été acquéreurs nets d'actions japonaises depuis 2003 et leur engouement pour le marché japonais d'actions s'est sensiblement affirmé avec l'optimisme croissant quant à la reprise économique dans l'Archipel. Selon certains stratèges du marché, les fonds d'arbitrage étrangers jouant simultanément sur des positions « acheteuses » et « vendeuses » ont apporté un appui déterminant au marché en décidant de « se porter acheteurs » d'actions japonaises. En outre, même si la hausse des prix du pétrole, qui ont battu de nouveaux records en termes nominaux, a créé ailleurs une certaine nervosité sur l'état de l'économie mondiale, les investisseurs étrangers se sont montrés relativement détendus quant aux effets des prix du pétrole sur le Japon qui s'est montré très efficient sur le plan énergétique par rapport à d'autres économies de l'OCDE.

En termes de moyennes mensuelles, l'indice Nikkei 225 a augmenté de plus de 14 % entre mars et octobre, soit légèrement plus que l'indice Euro Stoxx qui a progressé de plus de 12 % au cours de la même période (tableau 1). De décembre 2004 jusqu'au début octobre, l'indice japonais a aussi surpassé l'indice européen avec une poussée de plus de 20 % contre plus de 18 % en Europe. Parmi les indices des grandes économies de la zone euro, c'est le DAX 30 en Allemagne qui a affiché les meilleures performances avec une hausse de plus de 16 % entre mars et début octobre. Par rapport à l'Europe et au Japon, les marchés d'actions aux États-Unis se sont moins bien comportés alors même que l'économie américaine a enregistré et devrait enregistrer une expansion nettement plus rapide que celles de ces deux autres économies.

... notamment au Japon où les perspectives de croissance ont rendu les actions de plus en plus intéressantes pour les investisseurs étrangers.

Des disparités de performances selon les régions, avec une moindre croissance des marchés américains par rapport à l'Europe et au Japon.

Tableau 1. Évolution des indices boursiers généralistes et sectoriels dans les principales économies

	États-Unis	Japon	Zone euro	Allemagne	France	Italie	Royaume-Uni	Canada
<i>Indices boursiers généralistes</i>								
	WILSHIRE 5000	NIKKEI 225	DJ EURO STOXX	DAX 30	CAC 40	MILAN MIBTEL	FTSE 100	S&P/TSX COMP.
Var. % déc. 04-oct. 05	1.7 %	21.4 %	18.5 %	19.8 %	20.6 %	14.0 %	14.1 %	17.8 %
Var. % mars 04-oct. 05	2.2 %	14.0 %	12.2 %	16.1 %	12.7 %	8.0 %	9.4 %	11.1 %
CCR oct. 05 ^b	18.3	32.6	15.4	13.5	14.7	19.1	14.5	19.2
CCR moyen janv. 90-oct. 05 ^b	21.4	48.6	16.2	17.0	15.2	19.1	17.2	19.0
CCR moyen 90-94 ^b	17.7	48.8	14.2	17.5	12.5	17.8	15.5	19.3
<i>Télécommunications, médias, informatique^a</i>								
Var. % déc. 04-oct. 05	-3.7 %	16.4 %	5.4 %	0.8 %	7.5 %	-3.2 %	6.8 %	3.2 %
Var. % mars 05-oct. 05	1.6 %	12.7 %	5.4 %	6.6 %	8.9 %	-2.9 %	4.4 %	3.8 %
CCR oct. 05	25.7	31.5	20.4	19.3	15.7	26.2	16.5	26.3
CCR moyen janv. 90-oct. 05	29.5	62.6	21.9	31.7	19.7	21.1	24.3	28.6
CCR moyen 90-94	21.2	49.8	14.3	28.7	13.0	13.5	14.8	27.1
<i>Valeurs financières^a</i>								
Var. % déc. 04-oct. 05	-2.7 %	31.9 %	20.8 %	22.3 %	21.0 %	18.8 %	6.3 %	13.2 %
Var. % mars 05-oct. 05	0.4 %	22.1 %	12.6 %	15.0 %	14.1 %	10.1 %	4.5 %	8.3 %
CCR oct. 05	13.5	33.7	13.9	12.0	13.1	19.2	13.0	16.4
CCR moyen janv. 90-oct. 05	15.4	63.2	15.8	19.2	12.4	20.4	16.7	13.6
CCR moyen 90-94	12.5	61.8	14.8	22.1	11.2	18.5	18.4	12.7
<i>Dont : Banques^a</i>								
Var. % déc. 04-oct. 05	-8.3 %	37.1 %	19.4 %	25.0 %	16.6 %	20.9 %	2.5 %	14.2 %
Var. % mars 05-oct. 05	-4.7 %	28.2 %	11.5 %	16.9 %	12.5 %	11.0 %	2.9 %	9.7 %
CCR oct. 05	12.6	35.9	14.2	14.5	11.1	17.7	11.8	17.0
CCR moyen janv. 90-oct. 05	14.3	97.7	13.3	13.7	10.7	16.2	14.2	12.9
CCR moyen 90-94	11.3	65.3	10.6	13.4	9.5	11.1	14.6	12.4
<i>Sociétés d'assurance^a</i>								
Var. % déc. 04-oct. 05	1.0 %	31.4 %	18.7 %	15.0 %	33.0 %	10.4 %	21.1 %	20.2 %
Var. % mars 05-oct. 05	1.3 %	19.7 %	10.2 %	9.9 %	17.3 %	5.1 %	14.2 %	13.1 %
CCR oct. 05	13.2	29.4	11.3	8.5	16.0	20.6	12.5	11.3
CCR moyen janv. 90-oct. 05	18.3	44.5	20.5	31.6	14.2	29.3	23.7	13.5
CCR moyen 90-94	14.0	48.9	24.5	47.4	11.4	33.5	29.2	12.2
<i>Sociétés d'assurance vie^a</i>								
Var. % déc. 04-oct. 05	17.0 %	32.0 %	14.8 %	31.3 %	4.1 %	3.5 %	6.6 %	9.6 %
Var. % mars 05-oct. 05	16.4 %	14.4 %	9.4 %	18.7 %	3.6 %	0.3 %	-1.6 %	5.4 %

Note : Les calculs sont établis à partir de moyennes mensuelles (pour octobre 2005, les données vont jusqu'au 10 octobre uniquement). Les bénéfices par actions, qui constituent les dénominateurs des coefficients de capitalisation des résultats, reposent sur le dernier taux annualisé représentatif du dernier exercice ou ils sont calculés par agrégation des bénéfices des périodes intermédiaires. Pour la France, les bénéfices courants par action sont une prévision fournie par des sources locales. Pour le Royaume-Uni, les bénéfices sont calculés par une méthode d'analyse en glissement sur 12 mois reposant sur les comptes intermédiaires, de fin d'année et annuels.

a) Indices Datastream. L'indice des valeurs des assurances couvre les sociétés d'assurance non vie, les courtiers en assurance et les autres sociétés d'assurance, à l'exclusion des sociétés d'assurance vie.

b) Par rapport aux Indices du marché total calculés par Datastream.

Source : Thomson Financial Datastream.

Aux États-Unis, les investisseurs ont réagi à des nouvelles susceptibles de changer l'état de santé de l'économie. En mars et avril, par exemple, de mauvaises nouvelles sur le front économique ont provoqué une chute des marchés. En revanche, les nouvelles négatives sur l'emploi aux États-Unis qui ont été publiées début juillet ont suscité une forte hausse des principaux indices. Ce rapport sur l'emploi faisait état de chiffres inférieurs aux anticipations, ce qui a apaisé les craintes d'une surchauffe de l'activité qui aurait contraint la Fed à accentuer le rythme de ses mesures de resserrement monétaire. Dans la même logique, les chiffres supérieurs aux attentes concernant l'emploi non agricole aux États-Unis publiés début août au moment même de nouvelles hausses des prix du pétrole, ont exacerbé les craintes d'un resserrement monétaire anticipé qui aurait pu freiner l'activité, le tout déclenchant des replis temporaires des marchés d'actions.

Avec les incertitudes sur les perspectives économiques, les investisseurs sont sensibles à l'actualité économique,...

Malgré ces incertitudes, les marchés ont généralement bien résisté face aux catastrophes d'origine humaine ou naturelle. Les attentats terroristes du 7 juillet à Londres ont provoqué un recul de 1.4 % de l'indice de l'ensemble du marché britannique et une contraction de 1.1 %, de l'indice correspondant de la zone euro. Ces replis ont cependant été éphémères, puisque dès le 8 juillet, ces marchés avaient renoué avec leurs niveaux antérieurs. Les attentats de Londres n'ont, semble-t-il, produit aucun effet sur le marché américain et n'ont eu tout au plus qu'une influence mineure sur le marché japonais. A titre de comparaison, après les attentats du 11 septembre 2001 aux États-Unis et ceux de Madrid en mars 2004, il avait fallu plus d'un mois aux marchés des pays concernés pour retrouver leurs niveaux antérieurs à ces événements. Les indices généralistes des marchés ont aussi été à peine affectés par les ouragans Katrina et Rita, qui ont touché le sud-est des États-Unis à la fin du mois d'août et en septembre, le premier de ces ouragans ayant provoqué de lourdes pertes humaines et de vastes destructions d'infrastructures. Toutefois, l'augmentation des prix du pétrole au lendemain de ces tempêtes qui ont détruit des champs pétroliers et des raffineries dans le Golfe du Mexique a dernièrement pesé de façon plus générale sur les marchés et les marchés américains ont cédé

... mais les indices généralistes ont bien résisté face aux attentats terroristes et aux catastrophes naturelles.

*Même si le secteur
de la réassurance
a été mis à mal
par les récentes
catastrophes,...*

une partie du terrain gagné précédemment, même si, début octobre, ils se situent au-dessus de leurs niveaux de fin juin.

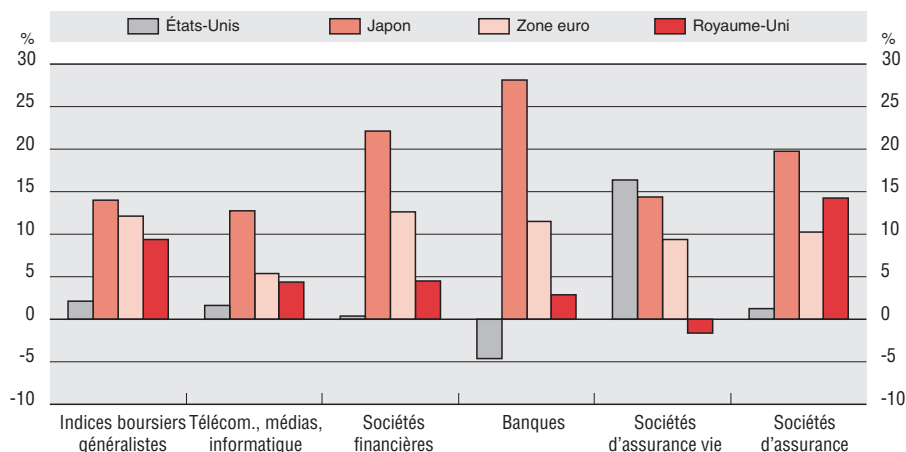
On ne sait pas encore dans quelle mesure ces ouragans vont porter préjudice aux résultats des sociétés d'assurance. Mi-septembre, de nouvelles pressions à la baisse de l'indice des prix du secteur de l'assurance se sont exercées à la suite de communiqués d'une grande société de réassurance qui, par suite de l'ouragan Katrina, a doublé ses estimations du total des sinistres assurés et a révisé en hausse ses chiffres provisoires concernant les demandes d'indemnisation auxquelles elle devrait faire face. Mais comme l'a montré l'expérience, dans le cas de certains assureurs, cette catastrophe ouvre la perspective d'un relèvement des primes qui viendra contrebalancer la tendance à la baisse des indices du secteur.

*... les secteurs
de l'assurance et
de la finance
se sont
généralement
bien comportés,
au Japon
notamment, tandis
que les indices
bancaires ont été
à la traîne
aux États-Unis.*

Ces derniers mois, les performances des indices boursiers du secteur de l'assurance ont été positives, puisque ceux-ci n'ont accusé qu'un léger retard par rapport aux indices généralistes aux États-Unis et en Europe. Les indices bancaires aux États-Unis ont enregistré des résultats inférieurs au marché dans son ensemble. Subissant le contrecoup de la hausse du loyer de l'argent et de l'aplatissement de la courbe des taux, l'indice des valeurs bancaires américaines a cédé plus de 8 % depuis la fin de l'an dernier jusqu'en octobre et près de 5 % depuis mars (tableau 1 et graphique 3). Une fois encore, le Japon s'est mieux comporté que les autres grands marchés, les valeurs financières surpassant un indice généraliste affichant lui-même une forte progression. Dans ce segment, les bonnes performances du secteur bancaire ont été portées par le succès des précédentes réformes qui ont renforcé les bilans des établissements de crédit. En outre, les chiffres publiés en août par la Banque du Japon ont montré que le crédit bancaire avait progressé pour la première fois depuis le début de la collecte de ces statistiques en 1998 ; cette bonne nouvelle est venue consolider la confiance quant au redressement de l'économie japonaise¹. Qui plus est, le secteur bancaire a été stimulé par les perspectives de fusion entre la deuxième banque japonaise, Mitsubishi Tokyo Financial Group, et UFJ, quatrième établissement du pays, pour créer le groupe Mitsubishi UFJ qui deviendra ainsi la plus grande banque du monde.

Graphique 3. **Performances récentes des indices boursiers sectoriels dans les principales économies**

Variations en pourcentage de mars à octobre 2005



Note : Les calculs reposent sur des moyennes mensuelles. Les indices correspondent à ceux du tableau 1.

Source : Thomson Financial Datastream.

Les hausses les plus vigoureuses enregistrées par les sous-indices du secteur financier japonais ont été le fait du secteur de l'assurance vie. Son indice a en effet progressé de 32 % pour les trois premiers trimestres de l'année civile et de plus de 14 % depuis mars. Le secteur de l'assurance vie a également surperformé les autres indices aux États-Unis, avec une hausse de près de 17 % de mars à octobre, alors que l'indice global des valeurs financières connaissait une quasi stagnation au cours de la même période. Sur les marchés européens, l'assurance vie a aussi affiché de bonnes performances avec une croissance de près de 10 % de mars à octobre. Le secteur des télécommunications des médias et des technologies de l'information (TMT), qui a été à la traîne par rapport aux indices généralistes dans les grandes économies, s'est relativement mieux comporté au Japon. En Europe, ce secteur a affiché une belle vigueur en France, mais en Italie il s'est inscrit en net repli de près de 3 % de mars à octobre.

Forte progression des cours également pour l'assurance vie, mais des résultats médiocres pour les TMT.

***Une volatilité dans
l'ensemble limitée
et des valorisations
loin d'être
spéculatives.***

Ces derniers mois, la volatilité est restée faible quand elle n'a pas connu une nouvelle diminution, restant en dessous de sa moyenne sur cinq ans sur tous les grands marchés d'actions (graphique 4). Cela vaut aussi bien pour la volatilité telle qu'elle ressort des prix des options (volatilité implicite) et pour la volatilité en termes de variations des cours des actions (volatilité historique). La première qui constitue implicitement un indicateur prospectif a été supérieure à la seconde depuis juin-juillet sur toutes les grandes places boursières. De même, ces derniers mois, les coefficients de capitalisation des résultats (CCR, qui reposent sur les bénéfices antérieurs) ont été en moyenne à peu près conformes, voire un peu inférieurs, à leurs moyennes de long terme, ce qui indique que la valorisation des marchés est loin d'atteindre des niveaux spéculatifs. Au Japon, les CCR restent nettement inférieurs à leurs moyennes de long terme.

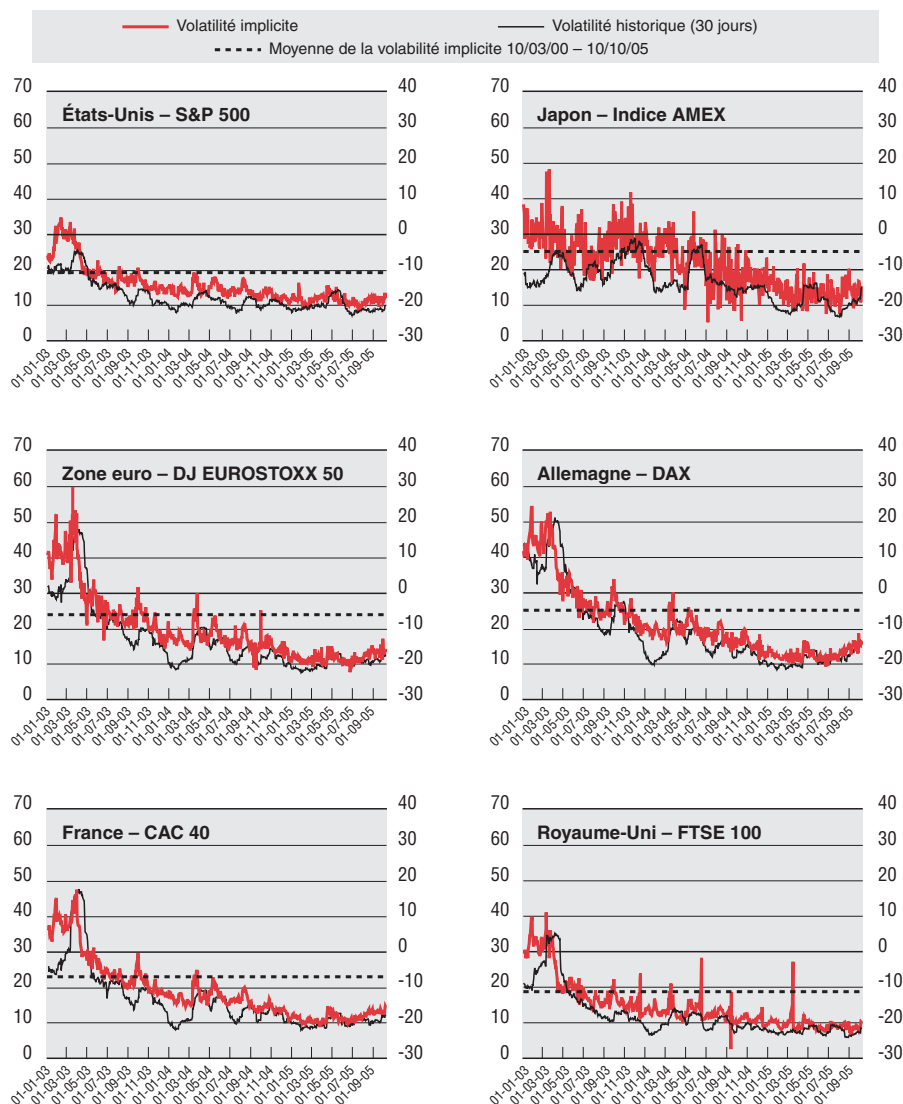
III. Marchés obligataires et taux d'intérêt

***Repli sensible
des rendements
de référence
à long terme dans
la zone euro,...***

***... aplatissement
de la courbe
des taux
aux États-Unis et
dans la zone euro,
mais accentuation
de sa pente
au Japon.***

Par rapport à l'an dernier, les rendements des obligations d'État de référence ont légèrement diminué dans l'ensemble aux États-Unis et au Japon et, de façon plus marquée, de l'ordre d'un point, en Europe (graphique 5).

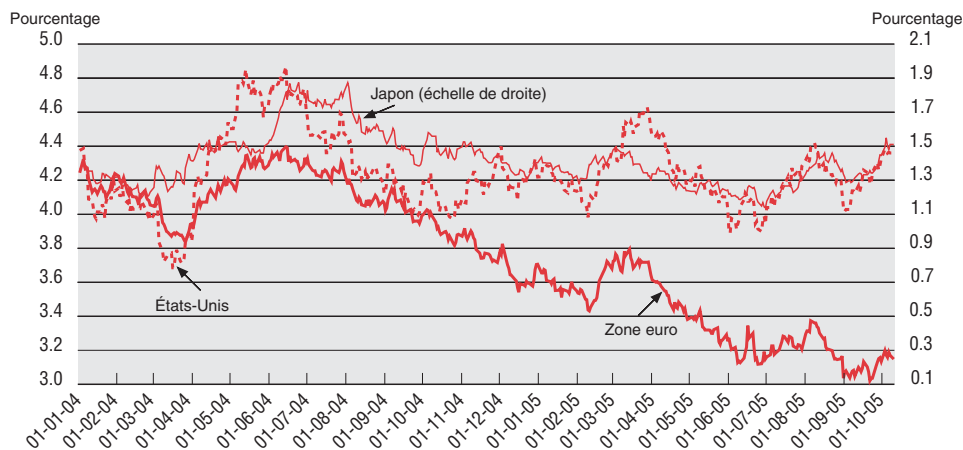
Parallèlement au resserrement en cours des conditions monétaires, les courbes des taux se sont aplaties aux États-Unis (graphique 6). La Fed a relevé son objectif de taux pour le porter de 1 % à 3.75 %, en 11 étapes entre fin juin 2004 et le 20 septembre 2005. Dans la zone euro, les taux directeurs restant inchangés, l'aplatissement de la courbe des taux est principalement venu de baisses des taux longs. Au Japon où les taux courts restent nuls, la progression des rendements à long terme induite par les perspectives économiques positives a abouti à une accentuation de la pente de la courbe. Au Royaume-Uni, la Banque d'Angleterre a réagi à une inversion de la courbe et est venue soutenir une économie en méforme en ramenant son taux directeur à 4.5 % le 4 août, déplaçant ainsi vers le bas une courbe des taux qui était aplatie. Face à une activité économique plus dynamique, la Banque du Canada a fait passer le 7 septembre son taux directeur de 2.5 à 2.75 %.

Graphique 4. **Marchés boursiers : volatilités implicites et historiques**

Note : Données quotidiennes jusqu'au 10 octobre 2005. Volatilités historiques sont volatilités mensuelles, calculées à partir des données quotidiennes. On peut considérer que la volatilité implicite est égale à l'anticipation par le marché du risque (volatilité future) et elle est calculée à partir des prix d'options d'achat à parité (interpolées) à l'aide de la formule de Black-Scholes. La méthode binomiale de Cox-Rubinstein est utilisée pour les options à l'américaine.

Source : Thomson Financial Datastream.

Graphique 5. Rendements des obligations d'État de référence à 10 ans



Note : Données quotidiennes jusqu'au 10 octobre 2005.

Source : Thomson Financial Datastream.

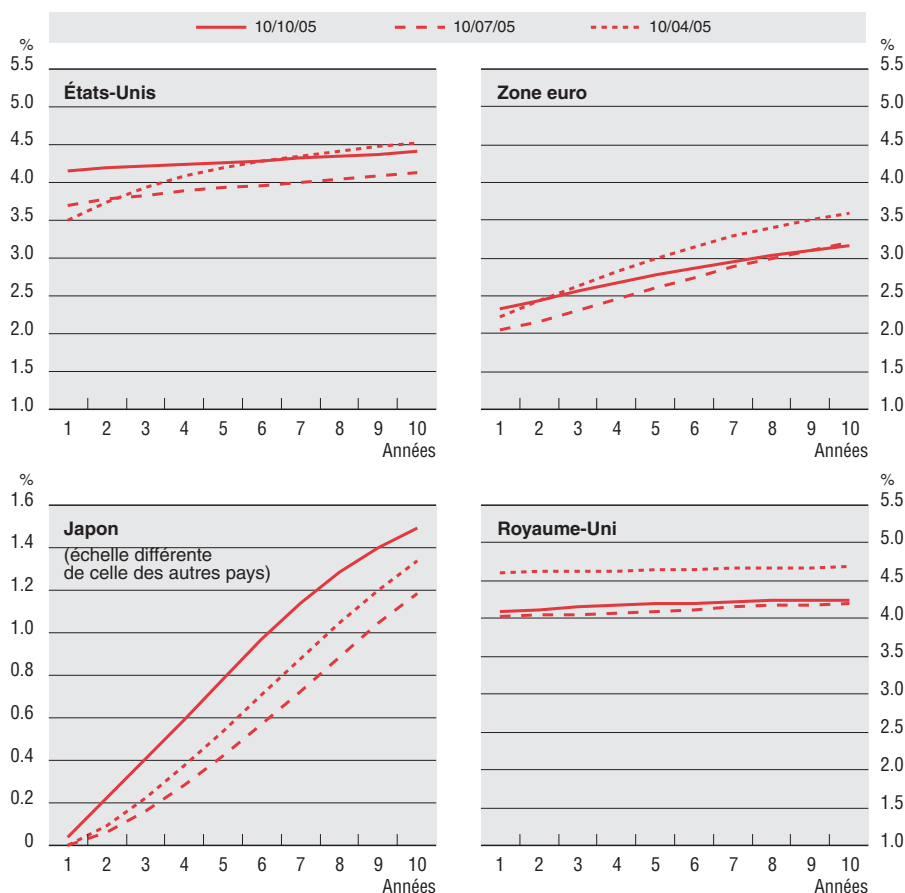
**Le marché s'attend
à de nouveaux
relèvements
des taux américains
et à un attentisme
de la BCE.**

D'après l'évolution des contrats à terme et des taux à terme tels qu'ils ressortent implicitement de la forme de la courbe des taux, on peut s'attendre à un nouveau resserrement des conditions monétaires aux États-Unis (graphique 7). Au lendemain de l'ouragan dévastateur Katrina, une certaine incertitude régnait quant à l'éventuelle interruption des mesures de relèvement de l'objectif de taux de la Réserve fédérale et, début septembre, les contrats à terme s'étaient inscrits en net repli. Toutefois, ces anticipations se sont rapidement dissipées, les contrats à terme retrouvant leurs niveaux antérieurs à la catastrophe. Dans la zone euro, toujours d'après les contrats à terme et les taux implicites à terme, il semble très peu probable que la BCE relève prochainement ses taux directeurs.

**Fluctuations
des rendements
de référence aux
États-Unis
en lien avec
les incertitudes
économiques.**

Aux États-Unis, malgré des fluctuations sensibles, les taux des obligations de référence à long terme sont demeurés à leur niveau moyen depuis le début de l'année et ont atteint environ 4.4 % début octobre. Entre-temps, ils ont enregistré deux accès de faiblesse, l'un début juin, l'autre à la fin du même mois. Le 1^{er} juin, les rendements des obligations du Trésor à 10 ans et à taux révisable sont revenus à leur niveau le plus bas depuis plus d'un an, après la publication

Graphique 6. Courbe des taux

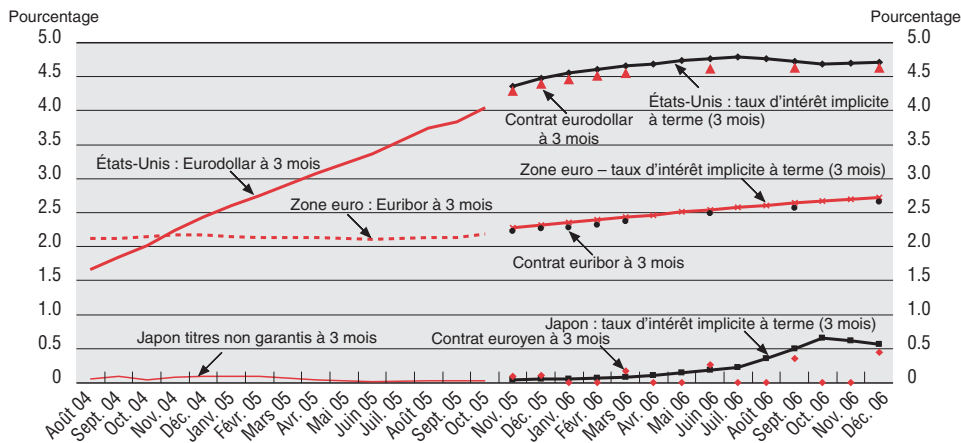


Note : Moyennes mensuelles des données quotidiennes.

Source : Thomson Financial Datastream.

de mauvais chiffres sur la production manufacturière et des rumeurs sur la fin prochaine du cycle de relèvement des taux de la Fed. Après un certain rebond, les incertitudes entourant la politique de la Fed ont provoqué un nouveau recul des taux dans la perspective de la réunion du Comité de politique monétaire du 30 juin. Comme le Comité a décidé de poursuivre ses mesures de resserrement, les prix des obligations ont baissé et les rendements se sont redressés. Par la suite, en août et jusqu'au début du mois de

Graphique 7. **Taux implicites à terme et taux des contrats à terme**
États-Unis, zone euro et Japon



Note : Données quotidiennes jusqu'au 10 octobre 2005. Taux effectifs : États-Unis : taux médian de l'eurodollar à 3 mois ; zone euro : Euribor à 3 mois ; Japon : taux médian des emprunts non garantis à 3 mois ; moyennes mensuelles. Les taux implicites à terme sont calculés à partir des courbes de rendement des obligations sans coupon. Contrats à terme sur eurodollar : contrat sur eurodollar à 3 mois (CME) ; contrats à terme sur Eurobor (LIFFE) : contrats à terme sur euroyen 3 mois (TIFFE).

Source : Thomson Financial Datastream, OCDE.

septembre, lorsque les prix du pétrole ont atteint leurs records du moment (67.5 USD pour le Brent de Londres le 2 septembre), les rendements se sont inscrits en repli. Lorsque l'ouragan Katrina a ravagé la région de la Nouvelle-Orléans, les craintes d'une recrudescence de l'inflation ont sans doute contribué pour une bonne part à la hausse des rendements. Mais avec la hausse concomitante des marchés d'actions, cette progression des rendements a pu aussi refléter des anticipations optimistes sur la croissance à long terme, avec la perspective d'un impact positif des travaux de reconstruction dans la région sinistrée.

**Des rendements
de référence
en repli dans
la zone euro,...**

Les rendements des obligations de référence en Europe ont suivi un schéma analogue, mais dans le sens de la baisse. Alors qu'ils étaient à parité avec leurs équivalents aux États-Unis en septembre 2004, l'écart par rapport aux rendements américains s'est creusé pour atteindre actuellement plus d'un point (environ 120 points de base début octobre). Comme les anticipations d'inflation sont maîtrisées, ce sont

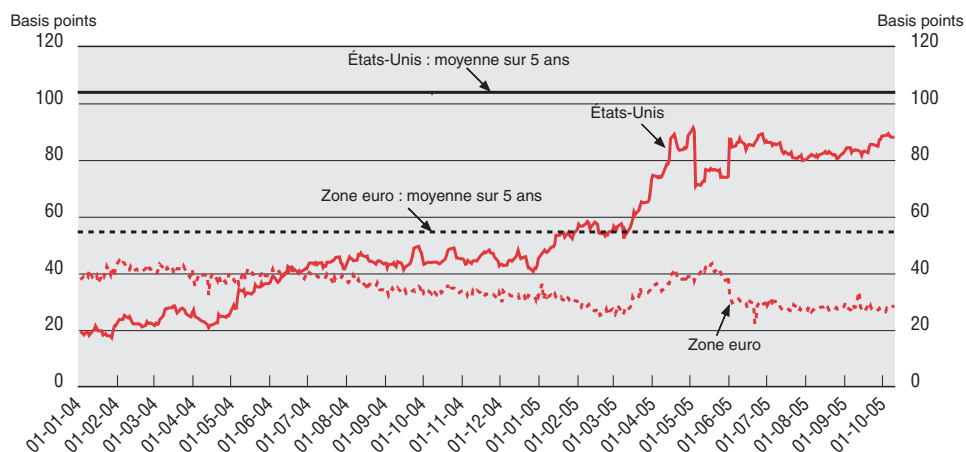
les perspectives de croissance médiocre qui ont été l'un des principaux facteurs à l'origine de ces évolutions. Par exemple, les prix des obligations d'État de la zone euro se sont redressés et les rendements ont baissé lorsque l'indice allemand du climat des affaires de l'Ifo publié fin mai s'est établi à 92.9 contre 93.3 en avril, soit son quatrième recul mensuel consécutif, et que l'enquête de l'institut allemand ZEW (Centre pour la recherche économique européenne) sur la confiance des investisseurs a donné des résultats plus mauvais que prévu. Des spéculations autour d'une réduction des taux de la BCE fin mai sont venues amplifier la baisse des rendements. Comme la BCE a maintenu le même cap, les anticipations relatives à la croissance ont favorisé la décreue des rendements. Peu après, cependant, les rendements ont été soumis à des tensions à la hausse sous l'effet du renchérissement du pétrole qui a alimenté les craintes d'un regain d'inflation et fait monter les rendements jusqu'au début du mois d'août, avant qu'ils n'établissent de nouveau des records de baisse durant la seconde quinzaine de septembre. Plus récemment, les rendements dans la zone euro se sont légèrement redressés aux alentours de 3.2 % début octobre.

Au Japon, les perspectives économiques positives qui se sont aussi reflétées sur les marchés d'actions, ont favorisé une progression des rendements obligataires à partir de la fin du mois de juin. Le léger recul intervenu vers la seconde quinzaine d'août a traduit la prudence des investisseurs avant les élections générales du 11 septembre. Depuis lors, les rendements ont repris leur ascension et, début octobre, ont renoué avec leurs sommets du mois d'août et du début de l'année.

Si les écarts de rémunération des obligations de sociétés restent inférieurs à leurs moyennes de long terme aux États-Unis et en Europe (graphique 8), ils ont sensiblement augmenté aux États-Unis en partie sous l'effet de facteurs de l'offre (voir plus loin). Les écarts de rémunération des obligations de la catégorie investissement, à savoir des obligations BAA par rapport aux obligations de référence, se sont creusés de quelque 50 points de base depuis le début de l'année aux États-Unis. En Europe, ils sont en revanche

*... et en hausse
au Japon.*

*Des écarts
de rémunération
des obligations
de sociétés toujours
faibles,...*

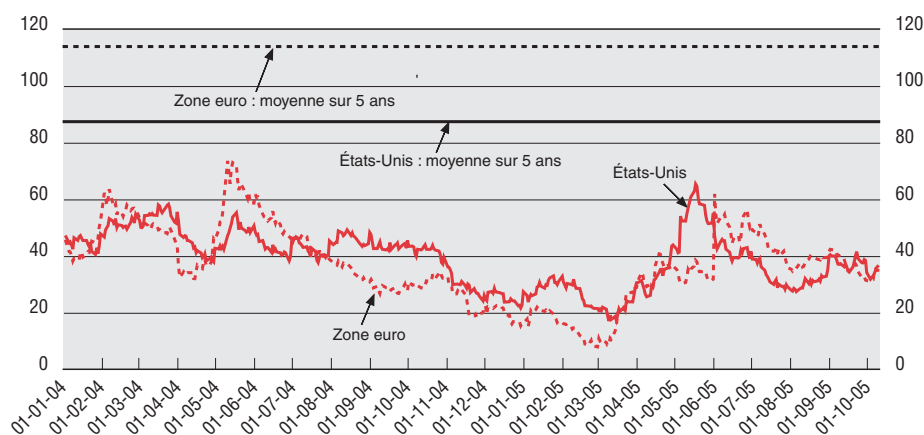
Graphique 8. **Écarts de rémunération des obligations de sociétés de la catégorie investissement**

Note : Données quotidiennes jusqu'au 14 février 2005. Rendements agrégés des obligations de sociétés notées BAA diminués des rendements des obligations d'État de référence.

Source : Thomson Financial Datastream.

restés stables pour l'essentiel, si l'on excepte une légère augmentation au deuxième trimestre, lorsque les faiblesses persistantes de l'économie de la zone euro sont devenues manifestes et ont déprimé les rendements des obligations de référence. Cette phase de creusement des écarts de rémunération s'est achevée par une chute de plus de 10 points de base début juin. Les écarts de rémunération entre les rendements des obligations à haut rendement et les obligations notées BAA sont eux aussi restés bien inférieurs à leur moyenne de long terme, malgré une légère augmentation dans les deux économies (graphique 9). A la mi-mai et début juin, les écarts de rémunération des obligations à haut rendement des deux côtés de l'Atlantique s'étaient accrus de quelque 170 points de base par rapport à leurs creux du début de l'année. Depuis lors, ils ont accusé un nouveau recul qui s'établissait aux alentours de 100 points de base début octobre.

Graphique 9. Écarts de rémunération des obligations à haut rendement



Note : Données quotidiennes jusqu'au 14 février 2005. Rendements agrégés des obligations de sociétés à haut rendement diminué des rendements agrégés des obligations notées BAA.

Source : Thomson Financial Datastream.

La faiblesse des écarts de rémunération des obligations de sociétés (de catégorie investissement comme des titres à haut rendement) est en partie le reflet d'une attitude globalement positive. La vigueur de l'expansion économique en général et de la croissance des bénéfices des entreprises en particulier a contribué à renforcer la confiance des investisseurs dans la qualité du crédit. En outre, les taux de défaillance des entreprises devraient rester faibles pendant un certain temps avant d'augmenter de nouveau en 2006. Les révisions en hausse des notations ont été plus importantes que les révisions en baisse aux États-Unis, même si des signes tendent à montrer que cet indicateur va continuer de baisser par rapport à son sommet de cette année. Les déclassements dans le secteur américain de l'automobile début mai² qui avaient provoqué un désengagement massif du marché obligataire, semblent ne pas avoir eu d'effets durables et, en juin, le secteur a recommencé à solliciter le marché des titres non garantis.

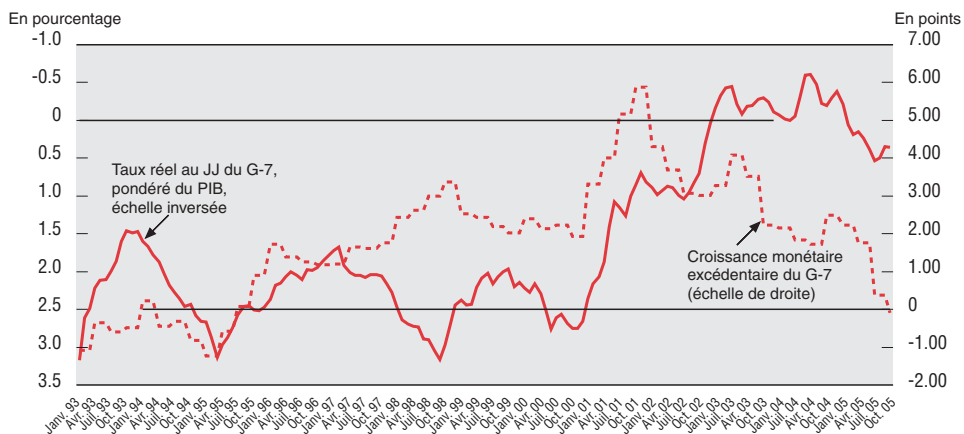
Les conditions de liquidité, qui ont continué de se contracter légèrement avec le resserrement de la politique de la Fed, sont néanmoins restées généreuses (graphique 10) et ont donc de nouveau contribué à maintenir des écarts de

*... grâce
à la confiance
des investisseurs,...*

*... mais aussi
à une liquidité
abondante.*

Graphique 10. Indicateurs de l'évolution de la liquidité mondiale

Taux réel de l'argent au jour le jour du G-7, PIB pondéré, échelle inversée, et croissance monétaire effective diminuée de la croissance réelle du PIB potentiel, en points



Note : L'indicateur de la liquidité mondiale fondé sur l'évolution des taux d'intérêt réel est inspiré de Borio et White (2004) « Whither monetary and financial stability ? The implications of evolving policy regimes », *BIS Working Paper* no 147. L'indicateur présente une moyenne pondérée des taux de l'argent au jour le jour des pays du G-7 ; pour la France et l'Allemagne, l'EONIA est utilisé à partir de 1999. Les pondérations reposent sur le PIB en dollar et les taux réels sont calculés en déduisant les moyennes mensuelles sur trois mois des variations de l'IPC en glissement annuel des taux réels au jour le jour, en prenant en compte les projections sur les variations de l'IPC lorsque l'on ne disposait pas des toutes dernières statistiques. L'autre indicateur s'attache à la croissance monétaire excédentaire du G-7 (également en moyenne pondérée du PIB). La croissance monétaire nominale effective est la croissance trimestrielle en glissement annuel des agrégats monétaires larges ; la croissance réelle du PIB potentiel est corrigée de la croissance tendancielle de la vitesse de circulation ; en d'autres termes c'est un indicateur de croissance monétaire résiduel calculé à partir de l'équation quantitative de la monnaie en prenant pour hypothèse une inflation nulle. La croissance tendancielle de la vitesse de circulation repose sur la croissance moyenne de la vitesse de circulation sur la période 1980-2002 dans les différentes économies, hormis pour la zone euro, où elle repose sur la valeur médiane de la fourchette de croissance de la vitesse de circulation correspondant à l'hypothèse de la Banque centrale européenne pour le calcul de la valeur quantitative de référence de la croissance monétaire (0.75).

Source : Thomson Financial Datastream ; OCDE, *Principaux indicateurs économiques* et Base de données des *Perspectives économiques* ; Banque centrale européenne.

rémunération réduits et à éviter les défaillances d'entreprises. L'ampleur relative de la liquidité se reflète aussi dans l'assouplissement des conditions de prêt, notamment aux États-Unis comme l'indique le sondage d'opinion sur les pratiques en matière de prêts bancaires réalisée par la Réserve fédérale auprès des responsables des prêts des établissements de crédit. L'enquête de la Banque centrale européenne sur les crédits bancaires dans la zone euro aboutit à des résultats analogues ; elle fait aussi apparaître une augmentation plus prononcée du pourcentage net des

banques faisant état d'un assouplissement des normes de crédit en juillet.

Outre ces facteurs, on observe aussi une augmentation structurelle de long terme de la demande d'obligations, ce qui contribue à maintenir les taux d'intérêt à de faibles niveaux. Le gonflement de l'épargne retraite dans un contexte de vieillissement des populations, par l'intermédiaire des fonds de pension notamment, ainsi que la demande émanant des économies asiatiques, surtout par le biais des interventions de leurs banques centrales sur les marchés des changes pour empêcher une hausse de leur monnaie, ont intensifié les pressions à la baisse des rendements. En outre, selon une étude récente, cette « surabondance de l'épargne »³ est dans une large mesure favorisée par l'augmentation de l'épargne des entreprises à l'échelle mondiale⁴. D'après cette étude, les entreprises auraient thésaurisé l'équivalent de plus de 1 000 milliards USD au cours des quatre dernières années, après s'être livrées à une débauche de dépenses à la fin des années 90. Cela représente un changement cinq fois plus important que celui de 200 milliards USD, voire plus, de l'épargne des marchés émergents de 2001 à 2005.

Des facteurs structurels de la demande ont aussi favorisé la modération des rendements.

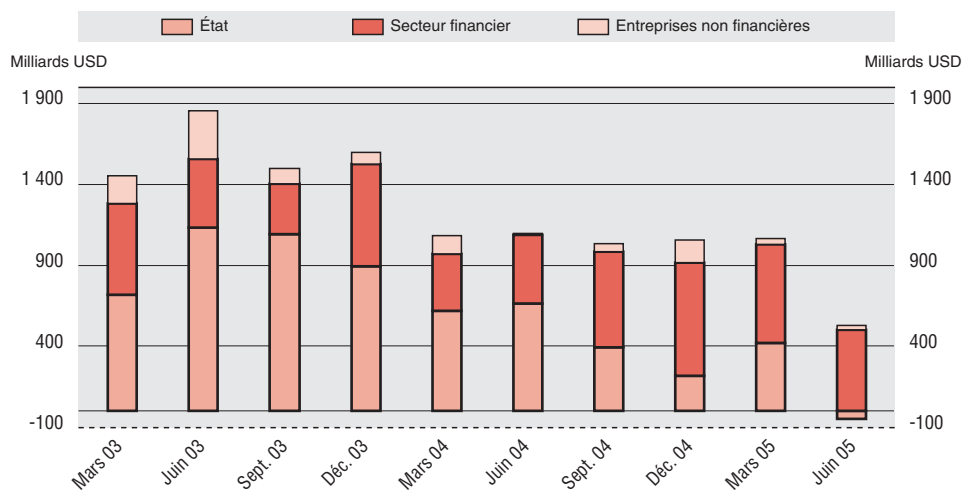
Si l'on examine les facteurs de l'offre sur les marchés obligataires, les émissions nettes d'obligations de l'État fédéral américain, qui étaient sur une pente descendante depuis le début de 2004, sont devenues négatives au deuxième trimestre (graphique 11). En dehors des facteurs de la demande évoqués précédemment, cette diminution de l'offre a fait grimper les prix des valeurs du Trésor et exercé une pression à la baisse des rendements. Au deuxième trimestre, les rendements des obligations américaines de référence à 10 ans ont subi un recul de quelque 60 points de base. De même, cette contraction de l'offre a été en partie responsable du creusement des écarts de rémunération des obligations de sociétés.

La baisse de l'offre de valeurs du Trésor américain a pesé sur les rendements...

Pour ces dernières en revanche, les facteurs de l'offre ont joué un rôle moins important. Même si les émissions nettes des sociétés non financières ont, en moyenne, diminué au premier semestre de 2005 par rapport aux moyennes des

... mais les émissions se sont maintenues ailleurs.

Graphique 11. **Émissions nettes d'obligations aux États-Unis**
En milliards USD, annualisés



Note : Les obligations d'État recouvrent les titres du Trésor, des municipalités et des organismes d'intérêt public.

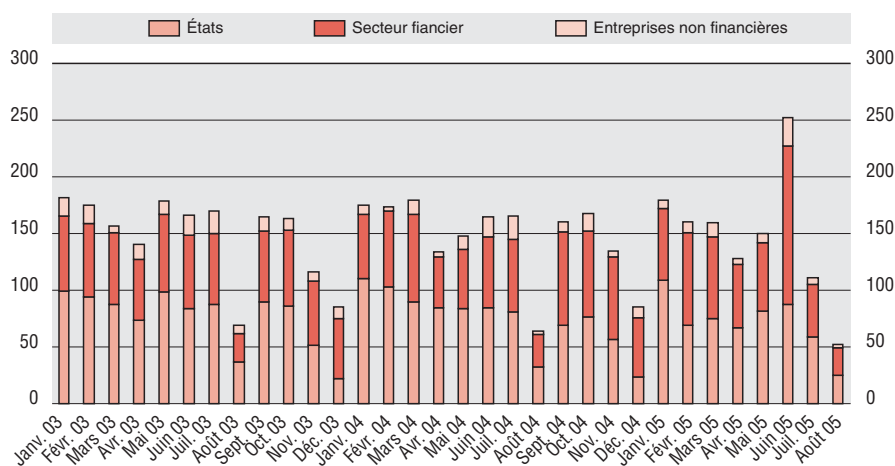
Source : Conseil des gouverneurs de la Réserve fédérale des États-Unis, *Flow of Funds Accounts of the United States*.

années antérieures, elles se sont relativement bien tenues. Cela a d'ailleurs été le cas pour le secteur financier qui, au cours des trois trimestres précédents, a émis la majeure partie des obligations américaines. Sur les marchés des obligations libellées en euros, les émissions sont restées importantes (graphique 12), même si l'on ne tient pas compte du gonflement des émissions du secteur financier au mois de juin imputable à des facteurs spéciaux⁵. Les émissions anticipées de juin expliquent sans doute la baisse des offres dans les mois qui ont suivi.

**Arrivée
de nouveaux
instruments à long
terme sur le marché
pour répondre
à la demande
des investisseurs
institutionnels.**

Pour répondre à la demande croissante des investisseurs institutionnels, notamment des fonds de pension et des sociétés d'assurance qui doivent assurer la congruence de leurs engagements à terme toujours plus éloigné avec leurs actifs, les pouvoirs publics ont encore accru leurs émissions d'obligations à ultra-long terme. Déjà en 2004, le Trésor des États-Unis avait émis des titres à 20 ans protégés contre l'inflation (les TIPS) et il a récemment annoncé son

Graphique 12. **Marchés des obligations libellées en euros :
volumes émis par type d'émetteur**
En milliards EUR



Note : Les émissions de titres « d'État » comprennent les obligations des organismes d'intérêt public, des États, des municipalités, régions, villes et organismes supranationaux. Les émissions du secteur « financier » comprennent les titres adossés à des actifs, les obligations émises par des institutions financières et les obligations hypothécaires (« Pfandbriefe »). Ces dernières comprennent des titres de type Pfandbrief émis dans les pays de l'UE, comme les obligations foncières en France, les Cédulas hipotecarias en Espagne, etc. On notera que conformément aux informations émanant de la Commission européenne, le gonflement des émissions des institutions financières et des sociétés non financières en juin 2005 semble être principalement liées à la date-butoir fixée au 1^{er} juillet 2005 pour l'application de la nouvelle Directive de l'UE sur les prospectus qui va imposer à la plupart des sociétés de mettre à jour leurs programmes d'emprunt avant de faire de nouveau appel au marché.

Source : Commission européenne (DG ECFIN).

intention de réintroduire une obligation à 30 ans début 2006. Les émissions de cette obligation à long terme avaient été interrompues en 2001 dans le contexte des excédents budgétaires. De la même façon, en 2004, le gouvernement italien a réussi à placer des obligations indexées à 30 ans dont un volume supplémentaire a été proposé cette année. En février, le Trésor français a émis une obligation à 50 ans. En mai, le gouvernement britannique a réintroduit un fonds d'État à 50 ans sur le marché après une interruption de plus de quarante ans. Cette émission a été suivie par une autre adjudication en juillet. En septembre, pour la première fois au monde, le Trésor britannique a mis sur le marché une obligation à 50 ans indexée sur l'inflation. L'obligation a été vendue par l'intermédiaire d'un consortium de banques.

Comme la demande à l'adresse de cette émission a dépassé 2 milliards GBP, le volume de l'offre qui était de 1 milliard GBP a été porté à 1.25 milliard. En outre, cette obligation était assortie d'un rendement réel de 1.112 % seulement, soit le plus faible jamais proposé pour une obligation indexée sur l'inflation, de 19 points de base inférieur à celui de l'obligation indexée à 30 ans.

***Forte expansion
des dérivés
de crédit,
les investisseurs
cherchant
à déplacer
les risques, ce qui
pose de nouveaux
problèmes aux
pouvoirs publics.***

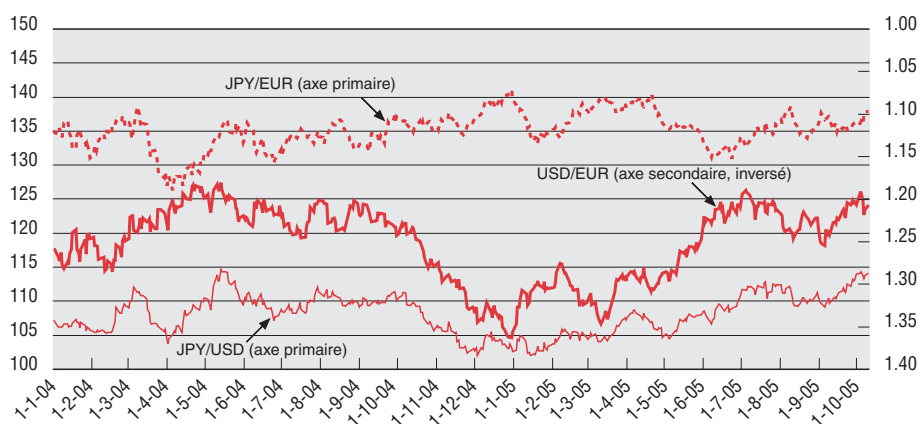
Pour le reste, le marché des dérivés de crédit a affiché une forte croissance cette année, car les banques, les fonds d'arbitrage et d'autres institutions ont sensiblement accru leur recours aux instruments financiers complexes, comme l'indique une récente enquête de l'International Swaps and Derivatives Association⁶. En juin, la valeur notionnelle totale de l'ensemble des contrats de dérivés de crédit en cours a atteint 12 430 milliards USD, soit un gonflement de 48 % depuis janvier et de 128 % sur un an. L'expansion de ce segment du marché met en relief les changements en cours dans le système financier mondial avec l'utilisation de ces instruments par les banques et les investisseurs à des fins de gestion des risques. Même si ces instruments présentent des avantages en tant qu'outils de gestion des risques, ils posent aussi des problèmes. Comme les transactions se déroulent de gré à gré et non pas sur des marchés organisés, c'est un secteur très opaque dont il est très difficile d'assurer le suivi. Cette expansion rapide a aussi provoqué des tensions pour l'infrastructure de négociation des banques et des fonds d'arbitrage dont les opérations de post-marché connaissent des retards considérables.

IV. Marchés des changes

***Un renforcement
du dollar américain
vis-à-vis de l'euro
et du yen,...***

De la mi-mars à la mi-juillet, le dollar des États-Unis a suivi une pente ascendante vis-à-vis de l'euro et, de façon un peu plus marquée, par rapport au yen, qui s'est lui-même légèrement apprécié vis-à-vis de l'euro jusqu'à la mi-juin (graphique 13). L'accès de faiblesse qu'a connu le yen contre dollar et contre euro a été le reflet de statistiques économiques médiocres (par exemple, un recul de la production industrielle de 2.3 % entre avril et mai) que les investisseurs ont interprétées comme des signes que la reprise de l'économie japonaise restait embryonnaire. A la mi-août, les

Graphique 13. Principaux cours de change



Note : Données quotidiennes jusqu'au 10 octobre 2005.

Source : Thomson Financial Datastream.

incertitudes quant à l'issue des élections générales prévues au Japon pour la mi-septembre ont de nouveau exercé des pressions à la baisse du yen. Fin août et début septembre, le dollar s'est inscrit en forte baisse à la suite des dégâts infligés par l'ouragan Katrina, pour s'établir à moins de 125 cents pour un euro ; toutefois, il a rapidement repris sa trajectoire pour ressortir aux alentours de 120 cents début octobre.

Selon certains analystes, cette vigueur inattendue du dollar a sans doute eu des effets négatifs pour les fonds de pension, les fonds d'arbitrage qui suivent la tendance et les investisseurs privés qui avaient parié sur une baisse du billet vert. Les investisseurs ayant apparemment tendance à vouloir de plus en plus négocier leurs risques sur le dollar, l'activité sur les instruments dérivés négociés sur les marchés organisés a augmenté de 15 % au deuxième trimestre pour atteindre un volume de 3 000 milliards USD⁷. Par ailleurs, les bénéfices réalisés à l'étranger par les grandes sociétés américaines se sont stabilisés ou ont reculé avec l'inversion du mouvement de baisse qu'avait connu le dollar tout au long du second semestre de l'an dernier. Avec la dépréciation du dollar, les résultats des filiales d'entreprises américaines à l'étranger étaient devenues une source importante de bénéfices pour les entreprises multinationales.

*... inattendu
pour certains,...*

*... mais qui reflète
les écarts
de taux d'intérêt
et de croissance...*

Pour de nombreux investisseurs, le déficit encore considérable des paiements courants américains ainsi que le gonflement des dépenses budgétaires des États-Unis avaient laissé entrevoir un nouvel ajustement à la baisse du dollar. Toutefois, des facteurs structurels plus immédiats ont favorisé le récent redressement du billet vert, notamment le creusement de l'écart de taux d'intérêt des obligations à long terme entre les États-Unis et la zone euro, ce qui traduit une détérioration des anticipations de croissance dans cette région et la vigueur persistante de la demande d'actifs américains.

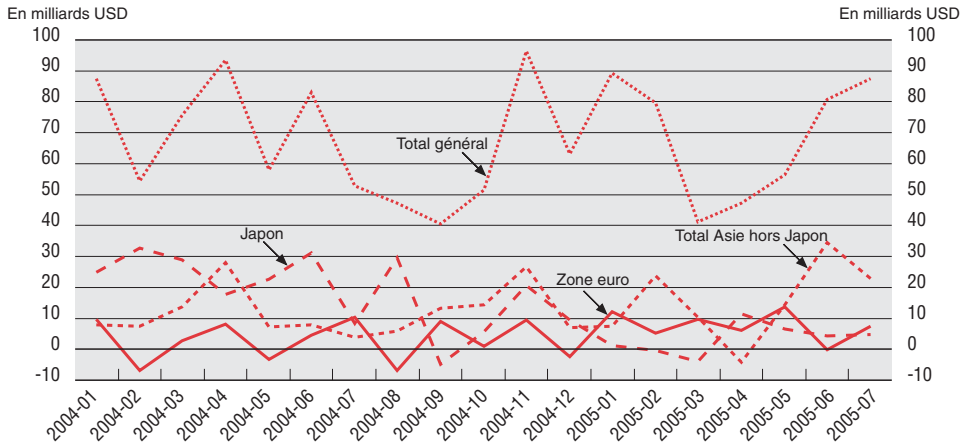
*... et un goût
persistant pour les
actifs américains,
notamment
de la part
des économies
asiatiques,...*

De fait, les entrées nettes de capitaux aux États-Unis sont restées très importantes (graphique 14). Alors que les entrées de capitaux venus du Japon se sont un peu infléchies ces derniers mois, la demande émanant d'autres pays d'Asie, en particulier la Chine, a progressé. En juin et juillet, les achats nets de titres américains par la Chine ont atteint 14.7 milliards USD et 13.8 milliards USD, respectivement, ce qui est proche du record de 16.9 milliards USD atteint en février. Une fois encore, la majeure partie de ces capitaux s'est placée sur des valeurs du Trésor américain, même si les achats d'obligations de sociétés ont connu une forte poussée en juin, jusqu'à représenter plus de 60 % de l'ensemble des achats nets d'obligations (graphique 15). Les investissements américains en actions étrangères intervenant parallèlement à une forte demande étrangère d'actions américaines, les entrées nettes de capitaux se plaçant en actions ont été à peu près équilibrées. En moyenne mensuelle, les non-résidents ont investi 350 milliards USD en actions américaines durant la période de janvier à juillet 2005, contre 330 milliards USD en 2004⁸.

*... et,
à moindre échelle,
des pays de l'OPEP.*

C'est le Japon qui détient la plus grosse part – plus d'un tiers du volume total – des actifs américains à l'étranger, tandis que les autres pays d'Asie en détiennent plus de 20 %, dont plus de la moitié pour la Chine. En outre, même si la part des pays de l'OPEP n'est que de 3 % environ des actifs américains détenus par des non-résidents, il convient de noter qu'au cours de l'année dernière, avec la montée en flèche des prix du pétrole, les exportateurs d'or noir ont investi une part de leurs bénéfices exceptionnels en actifs américains (graphique 16). Même s'ils ont diversifié leur portefeuille et se

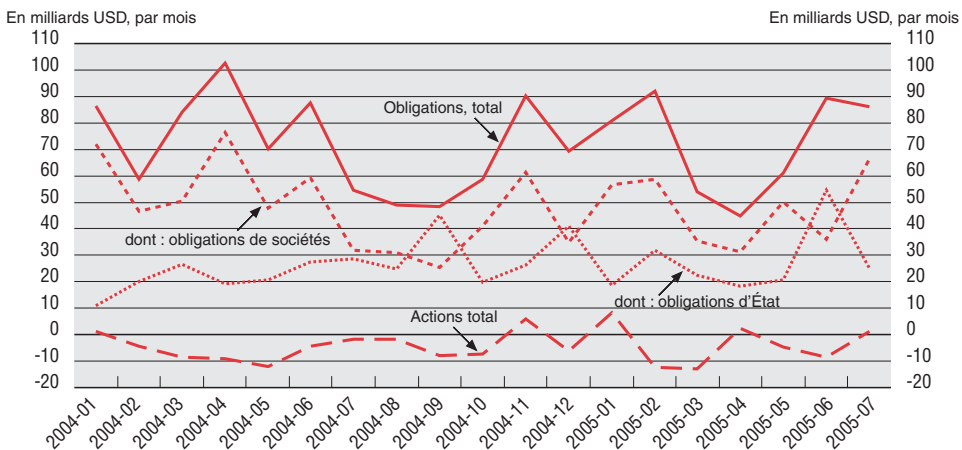
Graphique 14. **Placements de portefeuille nets de l'étranger aux États-Unis, par région**
En milliards USD



Note : Les placements de portefeuille nets sont les achats nets d'actifs par des investisseurs étrangers auprès de résidents des États-Unis (achats bruts – ventes brutes).

Source : Trésor des États-Unis, Treasury International Capital (TIC) Reporting System.

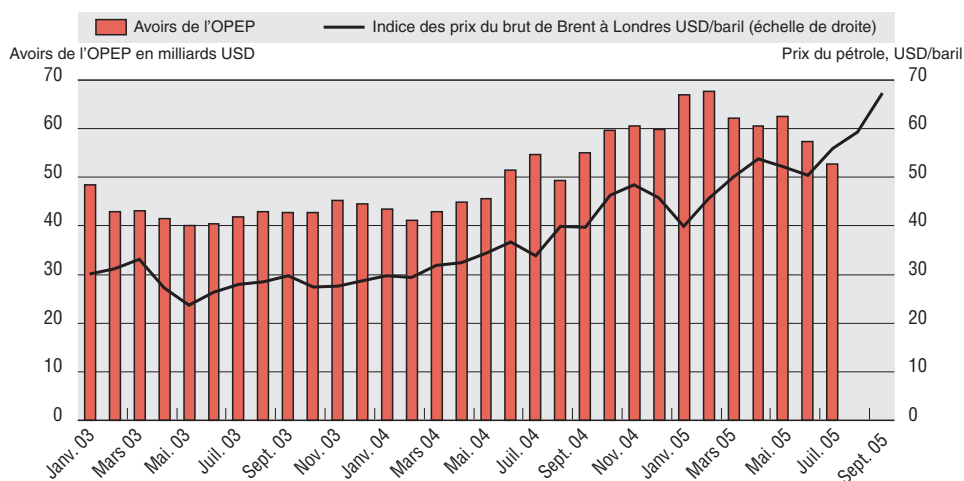
Graphique 15. **Placements de portefeuille nets de l'étranger aux États-Unis, par catégorie**
En milliards USD



Note : Les placements de portefeuille nets sont les achats nets d'actifs par des investisseurs étrangers auprès de résidents des États-Unis (achats bruts – ventes brutes). Les obligations comprennent des obligations américaines et étrangères ; les actions comprennent des actions américaines et étrangères.

Source : Trésor des États-Unis, Treasury International Capital (TIC) Reporting System.

Graphique 16. **Actifs américains détenus par les pays de l'OPEP**
Total des actifs américains détenus par des résidents des pays de l'OPEP,
en milliards USD et prix du pétrole en USD/baril, moyenne mensuelle



Source: Trésor des États-Unis, Treasury International Capital (TIC) Reporting System ; Thomson Financial Datastream.

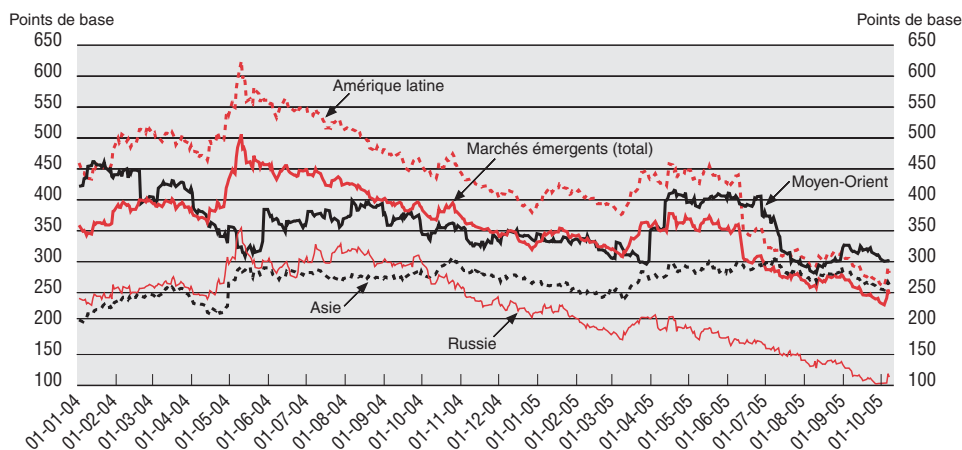
sont légèrement désengagés des actifs en dollar ces derniers mois, ils ne détenaient pas moins de 53 milliards USD d'actifs américains en juillet, soit plus qu'en juin 2004.

V. Marchés émergents

**Faiblesse record
des écarts
de rémunération
des indices
des marchés
émergents liée
en partie
aux perspectives
positives de
ces économies.**

La croissance des économies émergentes a continué d'attirer les investisseurs étrangers et même si son rythme devrait un peu se ralentir par rapport à l'année dernière, la croissance du PIB de ces économies reste bien supérieure à celle des pays de l'OCDE et est plus forte que celle de l'économie mondiale⁹. L'attitude positive des investisseurs s'est traduite par une nouvelle compression des écarts de rendement des indices des obligations des marchés émergents (EMBI) par rapport aux titres d'État américains, de sorte que ces écarts se sont établis à des niveaux d'une faiblesse historique début octobre (graphique 17). Cette compression des écarts est sans doute en partie motivée par les écarts positifs de croissance des économies émergentes par rapport aux pays industrialisés.

Graphique 17. Écarts de rémunération des marchés émergents



Note : Données quotidiennes jusqu'au 10 octobre 2005. Écarts de rendement interne des titres garantis et non garantis (rendements panachés) composant l'Indice EMBI Global de JP Morgan par rapport aux rendements des obligations de référence des États-Unis. L'indice EMBI Global couvre les obligations Brady, les euro-obligations, les obligations négociées et les titres d'emprunt des marchés locaux libellés en dollars émis par des entités souveraines et quasi souveraines.

On notera que d'après les informations de JP Morgan, la forte chute du 10 au 13 juin 2005 de l'indice pour l'Amérique latine et donc, de l'indice total des marchés émergents est dû à un rééquilibrage au cours du mois de juin provoqué par la conversion de la dette argentine. Par suite de ce rééquilibrage, la dette argentine en situation de défaut de paiement (avec des écarts de rémunération de 5 000 points de base et plus) a été en partie remplacée par des emprunts productifs assortis d'écarts de rémunération bien inférieurs.

Source : Thomson Financial Datastream.

La notation de la dette des marchés émergents a fait l'objet de révisions en hausse continues. Pour plus de la moitié de ses composantes, l'indice EMBI Global de JP Morgan appartient désormais à la catégorie investissement contre 10 % environ en 1998. Dans leur quête de rendement, de nombreux investisseurs institutionnels ont renforcé leurs positions sur les marchés émergents¹⁰. Face au gonflement de la demande, les emprunteurs de ces marchés ont accru leurs émissions pour les porter à un niveau record au cours des sept premiers mois de 2005, qui se situe à 22 % au-dessus du volume des émissions de la période correspondante l'année précédente¹¹. Récemment, mettant à profit la baisse des coûts de financement tout en étant confiants quant à la stabilité des conditions macroéconomiques, de nombreux émetteurs, notamment des gouvernements d'Amérique latine, ont procédé à des émissions libellées dans des grandes monnaies, principalement en dollar des États-Unis.

**Gonflement
des émissions
obligataires
des marchés
émergents
face à une demande
vigoureuse.**

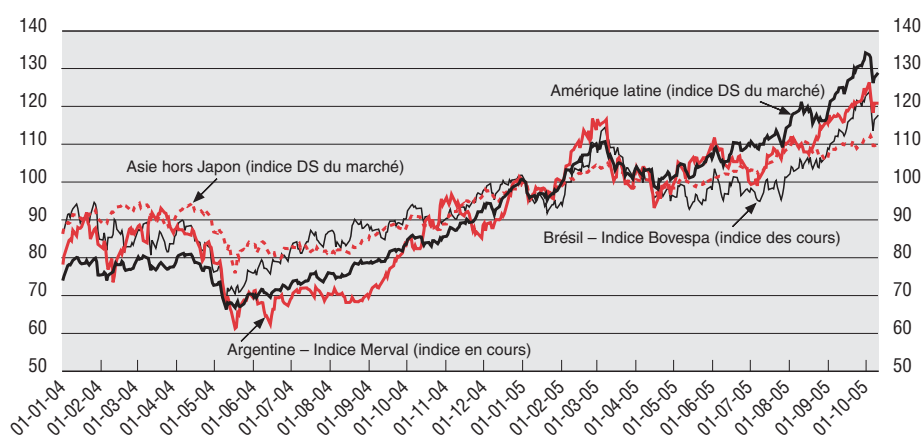
**Dynamisme des
marchés d'actions
des économies
émergentes,
notamment au
Brésil...**

Sous l'effet de la demande des investisseurs étrangers ainsi que de la demande intérieure, les marchés d'actions des principales régions émergentes ont connu un rebond (graphique 18). Ce rebond a été particulièrement prononcé en Amérique latine. Toutefois, il ne s'est produit qu'après des performances un peu moins bonnes au deuxième trimestre. Au Brésil, les incertitudes politiques liées aux accusations de corruption au sein du gouvernement ont entraîné un creusement des écarts de rémunération des obligations brésiliennes fin juillet, puis de nouveau fin août. Néanmoins, parmi les grands pays de la région, le marché brésilien d'actions a affiché parmi les meilleures performances de la période récente et, en termes de dollar, a largement surpassé les autres grâce au renforcement du réal.

**... et
restructuration
réussie de la dette
de l'Argentine.**

En Argentine, les investisseurs ont retrouvé la confiance après une restructuration réussie de la dette et sous l'effet d'une prévision de croissance de 7.5 % pour cette année, soit plus du double de la croissance de l'économie brésilienne. La restructuration de la dette argentine a été entreprise en février et les investisseurs se sont vu proposer quelque 35 milliards USD de nouveaux titres en

Graphique 18. **Performances boursières de quelques économies émergentes**
Indices d'actions, base 100 au 3 janvier 2005



Note : Données quotidiennes jusqu'au 10 octobre 2005.

Source : Thomson Financial Datastream.

échange de 100 milliards USD d'anciens emprunts avec des paiements d'intérêts au titre de ces derniers de plus de 600 millions USD. Avec une participation de 76 %, cette opération de restructuration a permis de ramener le poids de la dette à 72 % du PIB (contre 147 % en 2002 après la défaillance record du pays sur sa dette en décembre 2001), ainsi qu'une amélioration considérable du profil du service de la dette. Début juin, Standard and Poor's a révisé en hausse la notation de la dette à long terme de l'Argentine pour la porter à B- avec une perspective stable, alors qu'elle était notée SD (défaillance sélective). Cette décision de l'agence de notation a envoyé un signal positif aux investisseurs, restés prudents à la suite de la déclaration de cessation de paiement du pays pour un montant record en décembre 2001.

Si les écarts de rémunération des obligations asiatiques sont restés supérieurs aux rendements de l'indice total des marchés émergents depuis août dernier, ils n'en ont pas moins diminué de concert avec les écarts des autres marchés émergents. Le 21 juillet, la Chine a réévalué le yuan de 2.1 %, tout en introduisant un régime de flottement administré limité à 0.3 % par jour *vis-à-vis* du dollar. Par la suite, la Chine a annoncé une marge quotidienne de fluctuation hors dollar de 1.5 %. Pour réduire la nécessité d'intervenir sur de multiples marchés, la banque centrale chinoise a annoncé le 23 septembre un nouvel élargissement de la marge de fluctuation du yuan, ce qui autorise désormais des transactions portant sur d'autres monnaies que le dollar dans une fourchette de 3 % par jour.

Assouplissement de la politique des changes de la Chine sous l'effet des tensions suscitées par sa croissance économique vigoureuse.

Notes

1. Après correction de facteurs spéciaux comme la passation en charges de créances irrécouvrables, des variations de change et des opérations de titrisation, les chiffres de la Banque du Japon font apparaître une progression sur un an de 0.2 % des crédits en août qui atteignent 386 990 milliards JPY.
2. Le 5 mai 2005, Standard and Poor's a révisé en baisse les notations des constructeurs automobiles américains General Motors et Ford, pour les ramener en dessous de la catégorie investissement ; Moody's Investors Service lui a emboîté le pas le 25 août en ramenant la note des deux constructeurs au statut d'obligations à haut risque.
3. Cette expression (« savings glut ») apparaît pour la première fois dans une allocution prononcée par le Gouverneur Ben S. Bernanke, *The Global Saving Glut and the US Current Account Deficit*, lors de la Sandridge Lecture organisée le 10 mars 2005 par la Virginia Association of Economics, à Richmond, en Virginie..
4. Voir JP Morgan Research (2005), *Corporates are driving the global saving glut*, J.P. Morgan Securities Ltd, 24 juin.
5. Selon des informations émanant de la Commission européenne, le gonflement des émissions des institutions financières et des sociétés non financières en juin 2005 semble être principalement lié à la date butoir fixée au 1^{er} juillet 2005 pour l'application de la nouvelle directive de l'UE sur les prospectus, laquelle va imposer à la plupart des entreprises de mettre à jour leurs programmes d'emprunt avant de représenter sur le marché.
6. ISDA – International Swaps and Derivatives Association, Inc. (2005), *ISDA Mid-Year 2005 Market Survey*. New York, ISDA (également disponible à l'adresse www.isda.org). L'enquête de l'ISDA couvre les échanges sur le risque de défaillance et les obligations structurées adossées à des emprunts.
7. Banque des règlements internationaux, *Rapport trimestriel de la BRI*, septembre 2005.
8. Le total des entrées de capitaux aux États-Unis sur les marchés d'actions, qui se compose des achats étrangers d'actions américaines ainsi que des ventes d'actions étrangères détenues par des résidents aux États-Unis, s'est établi à 512 milliards USD pour la période janvier-juillet 2005, et à 469 milliards USD en 2004 (moyennes mensuelles). En comparaison, les entrées totales sur les marchés obligataires se sont élevées à 1 183 milliards USD pour la période janvier-juillet 2005 et à 1 065 milliards USD en 2004 (moyennes mensuelles).
9. Selon les *Perspectives de l'économie mondiale* du FMI (septembre 2005), la croissance du PIB du groupe des pays émergents a récemment été révisée à la hausse à 6.4 % pour 2005 et 6.1 % pour 2006, ce qui est supérieur à la croissance mondiale (4.3 % pour 2005 et 2006), ainsi qu'à la croissance des pays industrialisés (2.5 % pour 2005 et 2.7 pour 2006). Les *Perspectives économiques* de l'OCDE (juin 2005) estiment la croissance du PIB de l'ensemble des pays de l'OCDE à 2.6 % pour 2005 et 2.8 % pour 2006.

10. Un exemple est celui du fonds California Public Employees' Retirement System (CalPERS), le plus gros fonds de pension public des États-Unis, dont les actifs atteignent au total 182 milliards USD ; voir *CalPERS Adopts Emerging Market Debt Investment Policy*, Communiqué de presse, 15 juin 2005, disponible à l'adresse www.calpers.ca.gov/.
11. Banque des règlements internationaux, *Rapport trimestriel de la BRI*, septembre 2005.

Abstract: Governance of Banks in China

With the economic reform in the late 1970s, it has been an objective of government policy for Chinese banks to move away from their traditional passive role of executing directives adapted to the active role in resource allocation of banks in a market economy. However, owing to unclear ownership structures and a history of support of regional and industrial policy, most Chinese banks have had difficulty making the transition. This is particularly true for the four large state-owned commercial banks (SOCBs). In 1998-99, a significant effort to strengthen SOCB balance sheets was undertaken, but the results were disappointing. In the most recent phase of the reform, which began in 2003, the authorities concluded that further attempts at rehabilitation of the SOCBs had to address the issue of bank governance.

The key elements of the most recent phase of the reform, which began in 2003, are ownership diversification, public listing and expanded foreign presence, designed to subject all banks to higher standards of transparency and disclosure.

While the programme is bold, there are doubts about how bank restructuring will proceed. Ownership diversification and public listing thus far have generally not led to markedly improved performance for Chinese companies and thus their impact on banks is uncertain. Despite these uncertainties, the changes already introduced are so far ranging that there is no serious option of reverting to the old patterns of behaviour.

This article has also been published in *China in the Global Economy: Governance in China* (OECD, Paris, 2005), a study undertaken in the framework of the OECD-China programme of dialogue and co-operation.

Governance of Banks in China*

Executive summary

The conceptual framework for governance in banking reflects the special role of banks in a market economy. In order for the bank to act as a profit-oriented corporation, it must have genuine owners and the corporate governance regime should enable the owners to hold the management accountable for achieving a competitive return at acceptable risk. At the same time, banks have fiduciary obligations to depositors and also perform many “public good” functions such as acting as repository of savings, supplying currency and allocating resources in the real economy. Therefore, banks operate in a regulated environment.

There is a very close link between governance and supervision. The supervisors retain the right to determine whether their governance system, including their system of risk management, is appropriate. The modern paradigm of financial supervision relies on the bank's internal governance as the first “pillar” of bank oversight. The other two “pillars” are: i) surveillance by the market; and ii) official banking supervision.

With the economic reform begun in the late 1970s, Chinese banks have been moving away from their passive role under central planning. However, owing to unclear ownership structures and a history of support of regional and industrial policy, most Chinese banks have a governance regime that is not well adapted to the active role in resource allocation of banks in a market economy. This is particularly true for the four large state-owned commercial banks (SOCBs) which account for the predominant share of bank assets. Lacking profit-oriented owners to monitor bank management, the SOCBs have historically functioned as extensions of the government, with senior executives named by the party and approved by the State Council.

* This article was prepared by John Thompson, Financial Counsellor in the OECD Directorate for Financial and Enterprise Affairs. It has benefited from discussions with the OECD Committee on Financial Markets. The article has also been published as Chapter 13 in *China in the Global Economy: Governance in China* (OECD, Paris, 2005), a study undertaken in the framework of the OECD-China programme of dialogue and co-operation.

Part of the problem is that with their poor quality assets, the banks are financially weak. In 1998-99, a significant effort to strengthen SOCB balance sheets was undertaken with the sale of a large portion of non-performing loans (NPLs) to government-owned asset management companies. While resources committed to bank restructuring amounted to more than 16 per cent of GDP, the results were nonetheless disappointing. The financial quality of the big four SOCBs remained rather poor, with low earnings, inadequate capital, and continued high levels of NPLs. The authorities concluded that further attempts at rehabilitation of the SOCBs had to address the issue of bank governance.

In contrast to the SOCBs, the second largest category of banks, the 11 Joint Stock Banks (JSBs), have stronger earnings and better balance sheets. The JSBs, which are owned partly by the government and partly by other interests, do not have the historical legacy as instruments of supporting government policy and their management has a stronger commitment to profitability.

The key elements of the most recent phase of the reform, which began in 2003, are:

- improved ownership structures of SOCBs;
- government support for two “pilot” SOCBs, conditional upon improvements in governance;
- heightened competition between the SOCBs and other kinds of domestic banks;
- increased transparency and exposure of all Chinese banks to scrutiny by the market;
- an expanded foreign presence partly linked to Chinese WTO membership and partly linked to a desire to benefit from foreign competition.

Ownership diversification, public listing and expanded foreign presence are designed to subject all banks to higher standards of transparency and disclosure, with more intense scrutiny by banking counterparties, investment analysts, institutional investors and rating agencies. At the same time, measures to improve bank supervision were accelerated with the formation of a specialised independent agency for bank supervision (the China Banking Regulatory Commission or CBRC) and the enactment of a series of laws and regulations pertaining to bank supervision.

In December 2003 a special entity (Huijin) was set up to assume the state's ownership interest in the SOCBs. The “pilot” SOCBs will first be transformed into joint stock companies with the state as the sole owner and will receive cash injections to increase capital to adequate levels and build reserves against NPLs. The pilot banks are expected to find domestic and international strategic

investors to assume ownership positions and play an active role in corporate governance while Huijin represents the state's interest. The SOCBs will select their own management, which will be accountable for meeting the most commonly used benchmarks for earnings and balance sheet quality as well as targets for improvement in internal governance.

The JSBs have already been gaining market share in recent years and now have an opportunity to expand their share of the banking market yet further. To make further gains, the JSBs will raise capital by: *i)* domestic or international equity; *ii)* issues of subordinated debt; and/or *iii)* strategic investments by foreign banks. This will lead to changes in ownership structures and more intense market scrutiny for the JSBs.

While the programme is bold, there are doubts about how bank restructuring will proceed. On the one hand, competition may lead to a further contraction of the share of SOCBs in total lending, which could make the problems more manageable. On the other hand, it is not certain whether planned reforms are sufficient to make the SOCBs operate as market-based institutions. Continued majority state control of SOCBs with dispersed minority stakes may not result in effective monitoring of bank performance. The banks may be seen as “too big to fail”; they may still be perceived as benefitting from government support and therefore may not be exposed to full market competition. Ownership diversification and public listing thus far have generally not led to markedly improved performance for Chinese companies and thus their impact on banks is uncertain. Despite these uncertainties, the changes already introduced are such that there is no serious option of reverting to the old patterns of behaviour.

Introduction

This chapter analyses the special governance issues facing banks in China. Owing to their poor financial quality and their substandard governance systems, the major Chinese banks have been operating in ways that run counter to market-based rules of economic conduct. Since the onset of the reform in the late 1970s, awareness of the need to reform banks has grown. But banks have been slow to adapt their ways to the economic paradigms of a market economy and continue to lend support to state-owned enterprises, especially those that enjoyed the support of local government.

Efforts to change patterns of bank behaviour accelerated in the late 1990s, when the government sought to address the problem through providing funds to the banks for recapitalisation and for the removal of impaired assets from bank balance sheets. However, it soon became obvious that these measures were insufficient in scope to address the balance-sheet problems of banks and in any case

the provision of funds provided no incentive to prevent the banks from reverting to earlier patterns of lending.

Since 2003, efforts to reform banks have been accelerated, with one of the express objectives of the present reform being an improvement in bank governance practices. While most of these policy changes have been under discussion for several years, taken together, the measures to reform the banking system represent a major step in the direction of a market-based financial system. Specific reform measures include further upgrading of supervisory techniques in line with international practices as well as significant opening and liberalization of the banking system.

Since this study focuses on issues of governance, it will focus on those particular parts of the banking system where reforms aimed at improving governance are explicit policy aims. As a result, the note will not be a full analysis of the situation in the banking system. Measures specifically aimed at improving governance include a change in the ownership of commercial banks, an enlarged possibility for banks other than those entirely owned by the state to compete, improved internal control systems, greater transparency and market discipline, and more competition from foreign-owned banks. The aim of these measures is to strengthen incentives for bank management to operate the bank in the interests of financial return rather than in response to a mix of financial and non-financial considerations, some of which may be mutually inconsistent.

This chapter first considers the question of why the governance of financial institutions, and particularly banks, requires a special framework of analysis, and some of the distinctive governance issues that characterise banks. Subsequently, the specific issues facing the Chinese banking system will be addressed.

Governance in the banking sector

The role of financial institutions in a market economy

Financial institutions (banks, securities companies, pension funds and investment management companies) occupy a unique place in market economies. Financial institutions gather the savings of the public, exchange and analyse information about prospective users of financial resources, price risk, balance risk against return, and channel resources to those entities in the economy that seem most profitable while encouraging change in those where performance is deficient. To the degree that the behaviour of financial institutions deviates from this pattern, the economy will have difficulty in operating according to market signals.

Financial institutions operate in a highly regulated environment. All governments have decided that it is permissible to carry out financial business (banking, securities, insurance or pensions) only through a defined legal and regulatory framework and

have devised formal arrangements that stipulate the conditions under which it is permissible to solicit the savings of the public for various financial activities.

While financial institutions are expected to operate inside the normative framework that covers all corporate entities,¹ the governance structure of financial companies must also address some issues that are peculiar to the financial sector. Financial institutions typically utilise only small amounts of their own funds (capital) and instead deploy funds entrusted to them by the public. Financial institutions control large pools of assets and it is extremely difficult for the individual saver to monitor the ways in which financial institutions use those funds. Persons inside the institution, such as the management, brokers, traders, or money managers may not act in the interests of the client. Moreover, financial institutions frequently have ownership and control linkages to other key actors, such as allied industrial companies, governments, and local communities as well as their own management and workers. These linkages raise the risk of conflicts of interest and agency problems. Indeed, in emerging markets it is fairly common for these institutions to be “captured” by some group of outside parties. The governance regime has to build robust structures to protect the interests of parties to whom the institution owes a fiduciary duty.

Supervision and regulation are parts of the governance systems of the financial institution in a way that differs from non-financial institutions. Provisions in laws and regulations typically define products and prices, and licenses are required to engage in financial business. Furthermore, the supervisory authorities reserve the right to pass judgment on the adequacy of the governance of the institution.

Special characteristics of banking

The basic framework for governance of financial institutions has certain specific characteristics when applied to banking. Banks have special responsibilities regarding the issue of currency and the conduct of monetary policy. In most OECD member countries, a regime of deposit insurance guarantees that at least smaller depositors will be made whole even if the bank in which the deposit is made is unable to honour its commitments. By extending such guarantees, the authorities in effect remove the incentive for insured depositors to monitor banks, thus enabling banks to obtain funds without paying a risk premium fully commensurate with their risk profile. Systemic bank failures can have powerful negative effects on household wealth and on economic performance more generally. Furthermore, official rescues of failed banking systems are often very costly. For all these reasons, the authorities of most countries have decided that the banking supervisors may exercise higher degrees of control surveillance of the process whereby banks assume risks than is exercised over most companies and over other financial institutions.

Governance and banking supervision

While banking supervision entails a higher degree of control than other financial supervision, a process of deregulation has been occurring in finance over the past few decades. With deregulation, banking has become a highly competitive market-driven activity. In current conditions, banks are devising new product mixes and undertaking mergers and acquisitions and strategic alliances, frequently eroding the earlier lines of product segmentation. In current conditions, banks are allowed to compete much more freely than in the past and, at least in advanced markets, are under intense pressures to produce value for shareholders. The supervisory authorities are much more inclined than in the past to allow banks to determine their own risk preferences and to devise their own expansion strategies. Thus, the methods of bank supervision have evolved.

When a bank is adequately capitalised, the management places the capital of the owners at risk and the owners' investment is the first line of defence in maintaining financial integrity. It is plainly in the interest of the bank's shareholders to assure that high standards of profitability and financial soundness are maintained, since any deficiency on these scores ultimately falls on the bank's owners. The supervisor's main concern is to make sure that the bank operates within these parameters and does not experience a deterioration in financial condition that would shift the burden for risk-bearing to the public sector, by triggering government deposit insurance or by requiring intervention to assure the continuing operation of the bank or to prevent a disorderly bank failure that may cause systemic disturbances. Instead of the multiplicity of objectives and tight restrictions they faced in the past, banks are now expected: *i*) to earn adequate rates of return; *ii*) to observe high prudential standards and to maintain high quality risk management systems; and *iii*) to protect the interests of depositors.

Rather than criticising the bank's loan portfolio in detail, banks supervisors now see their role as one of engaging in dialogue with the directors of the bank and senior management about the risks the bank is taking, the quality of the bank's balance sheet and the systems that are in place to deal with those risks. Bank supervisors have systems under which they use a variety of quantitative and judgmental indicators to score banks under their own supervision.

Internal risk management and the credit culture

In order to protect the owners' investment and satisfy the requirements of supervisors, banks require strong internal "credit cultures" consisting of a strong in-house capability to analyse credit risk coupled with in-house systems to monitor the granting of credit and the assumption of risk. In competitive markets, the ability to characterise and price risk is a crucial determinant of whether the bank will survive and prosper. Credit analysts assign each proposed transaction a risk

rating, and based upon this rating a cost of credit is assigned. Only deals that clear the bank's profit hurdles are approved.²

The internal audit function assures that information disseminated internally and externally is accurate and protects the integrity of the disclosure process. The audit committee of the board of directors is the ordinary means by which the attention of the board is kept focused on the audit process. The responsibilities of this committee include communications, selection and oversight of external auditors, safeguarding risk management and internal controls, oversight of accounts, and communications with and oversight of external auditors.

Market discipline

Banks and their operations are expected to be under constant surveillance by the capital markets, where they issue bonds and equities, and by rating agencies who assess their creditworthiness. Banks engage not only in funding and lending to final customers, but also in a variety of operations, such as interbank lending and borrowing, foreign exchange dealing and trading of various assets in which they act as counterparties. The institution is expected to disclose reliable data that enable interested parties, such as depositors, investors and prospective counterparties, to reach an informed judgment about the creditworthiness of the institution. One routine operation of banks is to assess the creditworthiness of other institutions that are active participants in the market and modify the conditions under which they are willing to deal with other institutions. In performing this task, banks are typically assisted by credit-rating agencies and other suppliers of financial information.

A loss of credit standing is likely to be a leading indicator that a bank is encountering financial difficulty. Any lessening of the willingness of other banks to engage in credit activities, or increases in risk premiums charged for engaging in such activity would make it impossible for banks to function competitively. An increase in the cost of borrowing due to a perceived decline in creditworthiness is one of the principal ways in which market discipline is exerted over banks, and the judgment of the market is imposed on banks.

Shareholders and bank governance

The concept underlying the governance paradigm for banks is that the owners of the bank have placed their own capital at risk and the institution is to be operated, at least in very large part, in order to protect the investment of the owners and to produce a competitive yield to investors. Shareholders are entitled to the residual profits of the bank. Thus, if the bank should be especially successful, its owners will obtain most of the benefits. Conversely, the owners' funds equity (or capital) acts as a buffer in cases where the institution sustains losses due to inade-

quate earnings and/or losses on loans and investments. Thus, the shareholders have an important stake in maintaining adequate systems to monitor the management of the bank. The board of directors of the financial institution is charged with ensuring that the management is acting in the interests of the owners. It is important that the bank have a group of owners who actually behave in accordance with this paradigm and that the owners have effective means to monitor.

Banks in major industrial countries can generally be relied upon to act in accordance with this model. In emerging markets, however, experience shows that it is difficult to assemble a group of investors who can perform the normal moni-

Box 1. **Internal governance and banking supervision**

The relationship between the supervisory system of financial institutions and the internal governance of the institution has evolved significantly with deregulation. Previously, bank supervisors expended considerable effort validating financial accounts and examining individual loans, balance sheets and lending practices to check conformity with rules. These examinations often tended to occur at discrete time intervals. In the 1990s, however, banks began to innovate and to accept new kinds of risk. Many of these newer risks were not amenable to traditional examinations at discrete time intervals, since risk profiles changed rapidly within time periods. Simultaneously, the authorities have increasingly concluded that the responsibility for risk oversight must ultimately be the responsibility of the individual bank. The full process of oversight of banks consists of three elements: *i*) risk management and governance systems within the institution; *ii*) surveillance by the market; and *iii*) prudential oversight by the supervisory authorities.

As the nature of bank supervision evolved, supervisors increasingly insist on sound corporate governance inside the bank as the foundation of bank supervision. One aspect of bank governance is that the bank's directors and senior managers are responsible for seeing that banks have adequate risk management systems, including an internal audit function.¹ The revised global framework for banking supervision, commonly known as Basle II, places enlarged responsibility on the risk management systems of banks and establishes the accountability of bank boards and management for the adequacy of such systems.

The philosophy of banking supervisors with respect to the importance of corporate governance is spelled out in a statement by the Basle Committee on Banking Supervision, the international grouping that brings together banking supervisors from all major countries. This document highlights the crucial role that the board and senior management play in corporate goals and strategies, selection and appraisal of management, operations of risk controls and audit while building safeguards to minimise the risk of bank failure and to protect the interests of depositors.

Box 1. **Internal governance and banking supervision** (*cont.*)

The role of the board is crucial. The board is accountable to the shareholders, but also the supervisory authority. It names, monitors, compensates and, if necessary, removes the management. The board is responsible for the development of in-house systems to identify, quantify and manage risk.² The board is also responsible for the adequacy of the company's risk management and reporting systems.

While there is nearly universal agreement that the internal governance structure of the bank is the first line of defence in banking supervision, the exact specification of the role of the internal governance system differs in some degree among banking supervisors. The Governor of the Reserve Bank of New Zealand (RBNZ) states that "the ultimate responsibility for ensuring that risks are properly identified, monitored and controlled, lies in the boardroom and not with the supervisor". The RBNZ stresses the responsibility of bank directors in ensuring that a sufficient number of independent directors are on the board and that the board and senior management be accountable for devising strategies for the bank to thrive and earn adequate income while maintaining adequate internal systems for risk control.³

In an analysis specifically keyed to the situation of emerging Asian markets, Dr. Estanislao, President of the Institute of Directors of the Philippines, defines building board oversight capacity as an urgent priority for bank supervisors, especially in emerging markets which are often characterised by histories of government directed lending and of linkages between the banks and industry and government. The need to sensitise directors to their role in providing oversight to management and to defending the interests of minority shareholders is especially important in emerging markets. In order to do this, banks are required to provide prospective training to directors to explain their responsibilities and also to require minimum numbers of independent directors and specialised committees on audit, risk oversight and governance. The majority of directors of these committees should be independent. Estanislao also emphasises the need to develop rigorous definitions of independent directors and to use various tools to assess the quality of bank governance, such as the balanced scorecard approach.⁴

1. Bies (2002), pp. 1-2.

2. Basle Committee (September 1999).

3. See Bollard (2004).

4. See Estanislao (2004).

toring roles of shareholders. Domestic capital markets have not developed to the point that dispersed groups of domestic investors can act as effective monitors. Domestic strategic investors often have links to domestic industrial groups and hence the risk that the bank may be captured by domestic industry is always present. As a result, many emerging markets have found that efforts to reform bank governance require an expanded presence by foreign strategic investors. (This issue will be considered at length in the discussion of the Chinese case.)

When banks have no real owners, when the bank's capital is inadequate (or can be made to appear adequate only with regulatory forbearance), there is a likelihood that the management will engage in dysfunctional behaviour. Banks may take on excessive risk or they may engage in adverse credit selection in order to enable weak borrowers to maintain payments. Thereby, they increase their exposure to poor credits and conceal the true state of their balance sheets.

Governance of banks in China

Historical legacy

China's experience is distinctive inasmuch as between the early 1950s and the 1980s the economy functioned as a centrally planned socialist economy, with a system based upon state ownership in which a central authority issued directives that lower echelons executed.³

With the introduction of market reforms around 1980, a partial modification of the pattern of financing occurred. Some separation of commercial banking from the central bank took place, with the PBC focusing on its role as central bank. The banking system was expanded and diversified to meet the needs of the reform programme. New budgetary procedures permitted state enterprises to retain profits and to remit to the state only a tax on income and to seek investment funds in the form of bank loans. Between 1979 and 1985, the volume of deposits nearly tripled and the value of bank loans rose by 260 per cent. Meanwhile SOEs became dependent upon bank loans rather than budget transfers for external finance. Further institutional reforms were accelerated in 1994, when the policy execution function of banks was separated from the commercial banking function, with new specialised "policy banks" being formed. In theory, the commercial banks were expected to act in accord with market-based principles of finance, but owing to conflicting motivations of bank management, banks have been slow to change patterns of behaviour.

The present situation in the banking sector

After two decades of partial and at times contradictory reform, the banking system shows some prominent characteristics:

1. China has a very high savings rate, with savings averaging about 40 per cent of national income. The public holds the preponderant share of its savings in the form of bank deposits.
2. The post-1994 series of reforms, designed to subject the state-owned enterprises (SOEs) to greater market discipline, have been only partly effective. The formal financial system (*i.e.* banks and securities market institutions) has had only limited success in instilling discipline in the SOEs. Many SOEs operate at a loss, partly because the SOEs have limited flexibility to control the size of their labour forces and still undertake many operations that are not closely related to their basic economic functions. This situation has been ameliorated somewhat by reforms in the SOE sector after 1997, but pressures from SOEs and local governments remain strong.
3. The private sector, which has been the source of the economy's dynamism over the past two decades, has been obliged to use informal finance for its expansion.
4. The financial quality of Chinese banks, especially the state-owned commercial banks (SOCBs), is rather poor, with low earnings, inadequate capital, and high levels of non-performing assets. Indeed, most SOCBs would probably be insolvent if their balance sheets were subjected to careful scrutiny using strict loan classification standards.
5. A process of adverse credit selection is at work in which one of the main motivations of the banks is to extend enough credit to weak but privileged borrowers to stave off bankruptcy. There is a certain symbiosis between the SOEs and the banks which have some motivation to continue lending to weak SOEs in order to avoid report credits to such SOEs as non-performing.
6. As currently structured, the governance system of Chinese banks is not well suited to operating as profit-seeking institutions under which the bank aims at providing a competitive yield to shareholders and maintain high prudential standards. This is particularly true of the major state-owned commercial banks (SOCBs). The banks do not have clear owners. The management of the banks is not conducted by professional managers with a clear mandate to return value to shareholders, but by government officials whose goal is to achieve a balance of economic and non-economic objectives.

Box 2. Chinese banks under central planning

Under central planning, financial institutions played a passive role and were expected to check on conformity of lower-level actors with the objectives and directives of the plan. The Ministry of Finance exercised firm control over the banking system, credit, and the money supply. The People's Bank of China (PBC) essentially functioned as the "monobank" characteristic of centrally planned economies. As the central bank, the PBC had sole responsibility for issuing currency and controlling the money supply. It also served as the government treasury, the main source of credit for economic units, the clearing centre for financial transactions, the holder of enterprise deposits and the national savings bank. As a result, the skills of credit assessment and the use of financial tools to guide the conduct of enterprises did not develop.

There were some specialised banks alongside the monobank. The Bank of China (BOC) handled financial transactions with foreign firms and individuals as well as all operations in foreign currency. The Agricultural Bank provided financial support to agricultural units, issuing loans, distributing state appropriations for agriculture and overseeing the operations of the rural credit co-operatives. The China Construction Bank (CCB) managed state appropriations and loans for capital construction. It checked the activities of loan recipients to ensure that the funds were used for their designated construction purpose. Money was disbursed in stages as a project progressed.

Rural credit co-operatives were small, collectively owned savings and lending organisations that were the main source of small-scale financial services at the local level in the countryside. They handled deposits and short-term loans for individual farm families, villages, and co-operative organisations. Subject to the loose direction of the Agricultural Bank, they followed uniform state banking policies but acted as independent units for accounting purposes. Urban credit co-operatives began appearing in the mid-1980s. As commercial opportunities grew in the reform period, the thousands of individual and collective enterprises that sprang up in urban areas created a need for small-scale financial services that the formal banks were not prepared to meet.

The institutional structure of the banking system

The system contains five levels of banks. These banks differ in terms of their ownership structures, client base, governance structures and their balance-sheet quality.

State-owned commercial banks (SOCBs)

The four big SOCBs were created in their present form in 1994 with the passage of the Commercial Banking Act. This Act separated the commercial banks, which were supposed to operate in accordance with market criteria, from the

policy banks, which were expected to execute government policy. The four SOCBs are the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC) and the China Construction Bank (CCB). These banks have extremely large nationwide branch networks, large numbers of employees and a workforce of some 1.7 million.

At the end of 2000, the SOCBs accounted for some 75 per cent of banking assets, but their share has been declining in recent years as credit has expanded rapidly and other banks have been able to gain a market share. By the end of the first half of 2004, data from the CBRC showed that their share had fallen to about 55 per cent of total bank assets, as well as 57 per cent of deposits and 55 per cent of lending, but SOCBs still handled 80 per cent of payments and settlements. By volume of assets, the SOCBs are among the 50 largest banks in the world and the 10 largest in Asia.

Even on the simplest organisational level, the SOCBs lack the basic attributes of profit-making banks. In mid-2004, these banks had not yet been transformed into a corporate form and have not been fully separated from the Ministry of Finance (MOF). The banks do not have identifiable owners, boards of directors, or any of the specialized organs generally considered necessary for monitoring management, and are not subject to the governance rules that apply to independent banks. Like all Chinese companies, these banks have an external board of supervisors that is designed mainly to monitor conformity of bank acts with regulations and policies, but has no role in the governance or oversight of the management of the bank. Disclosure requirements are minimal. The bank is accountable only to the government, *i.e.* the MOF or the CBRC.

The management has traditionally been selected from inside the ministerial system, approved by the State Council, and subject to the close control of the Communist Party. The general manager (or chief executive officer, CEO) traditionally is subject to few checks and balances inside the bank. Senior managers tended to be from the civil service and to move between assignments in the banks and those in government ministries. The presidents of the SOCBs have the rank of vice-ministers. Bank management is not under a clear mandate to return value to the owners of the company or even to protect the interest of the owners, but instead responds to a variety of pressures from within the bureaucracy or the Communist Party, or from local governments.

Control over the operations of regional branches of the SOCBs has been a problem. Many local branches are subject to the influence of local industry, governments and the party. The traditional commitments of SOCBs are to distribute credit among regions and to support state-owned enterprises (SOEs), which in turn are responsible for maintaining employment and for making payments to retired workers as well as maintaining facilities such as schools and hospitals. Some progress has been

made in relieving SOEs of the responsibility of supporting non-essential activities and in assuring payments for retired workers. In addition, the SOCBs have been given more autonomy in credit decisions. Nevertheless, local governments still have a considerable say in how bank credits are distributed.

The SOCBs have traditionally had poor credit assessment and control systems, and in any case they were not structured to exercise credit discrimination. The SOCBs have serious problems of asset quality, earnings inadequacy, inadequate capitalisation and balance sheet quality. Earnings tend to be low, due to high costs, low margins on lending and failure to develop non-interest sources of income. Data indicate that the return on assets of SOCBs is in the range of 15 basis points. Internationally, a return norm of 100 basis points is considered adequate, and many emerging markets have far higher rates.

The large volume of non-performing loans (NPLs) in China is concentrated in the SOCBs. CBRC data indicate that at the end of 2003, NPLs of the SOCBs accounted for 80 per cent of NPLs in the banking system and that the NPL ratio was 20 per cent compared to 8 per cent for the joint stock banks and 17 per cent for the policy banks. Furthermore, reserves against NPLs are insufficient, with BOC and CCB having reserves adequate to cover 10-20 per cent of NPLs and the two other SOCBs having lower coverage ratios. Banks in other East Asian countries have NPL coverage ratios averaging around 75 per cent. The SOCBs as a group do not have sufficient capital to meet the minimum 8 per cent capital assets ratio. (However, as will be explained below, the two “pilot” SOCBs now have ratios in excess of 8 per cent.)

Although the balance-sheet quality of SOCBs is already poor using existing data, there is a clear suspicion that reported data give a misleadingly positive picture of the financial state of the SOCBs. There are strong incentives for the management of banks to misclassify assets, since reporting of high NPLs would expose the bank to sanctions from the authorities and it is uncertain whether any benefits would result from more accurate reporting.

The authorities have recognised the poor earnings and balance-sheet quality of the SOCBs for several years. At first, the authorities tried to address the problem with cash infusions to strengthen the bank balance sheets. In 1998, capital of RMB 270 million (3 per cent of GDP) was injected into the four SOCBs. In 1999, the government purchased NPLs for RMB 1.4 trillion (about 20 per cent of the outstanding loans and 15 per cent of GDP) from the SOCBs (as well as some assets from China Development Bank) at face value.⁴ As these figures suggest, expenditure on rehabilitating the banking system has already been very significant. The government also lowered reserve requirements and allowed the SOCBs to invest the funds deducted from reserves to purchase special non-negotiable 30-year government bonds, with coupon rates of 7.2 per cent. Simultaneously, the banks

were warned to cease lending to poor customers and to adapt their internal credit systems.

Despite this significant support in the form of public resources, bank behaviour did not change sufficiently. True, banks cut back on lending to some borrowers of doubtful creditworthiness. The financial performance of the banks still remained substandard while SOCBs still functioned as appendages of the state rather than as true financial intermediaries. The authorities concluded that any further support should only be extended in circumstances in which SOCBs had strong incentives to focus on financial performance. Therefore in the most recent round of restructuring in 2003-2004, efforts to strengthen the balance sheets of the banks have been tied to efforts to modify the governance regime of the SOCBs.

The policy banks

Three “policy banks” (the Agricultural Development Bank of China, the Development Bank of China and the Export Import Bank of China) were created in 1994 to assume the state-directed lending previously undertaken by the commercial banks. The policy banks accept few deposits and are funded mainly by government deposits and guaranteed bond issues. These banks are expected to fund infrastructure and development projects. The policy banks accounted for 14 per cent of banking assets at the end of 2003. Their NPL ratios were lower than those of the SOCBs.

Joint stock commercial banks (JSBs)

There are 11 banks which have been operating in the corporate form for several years. (The first JSBs were formed more than 10 years ago.) The equity of these banks is partly owned by the state and partly by other interests, such as state-owned enterprises, private enterprises and minority investors. One bank, China Minsheng Bank, is entirely owned by non-state entities.⁵ Since they are organised as corporations, they are required to have shareholder meetings and boards of directors and to produce accounts. As explained below, the JSBs are subject to additional governance requirements established by the banking supervisors. Five of these banks are listed on domestic stock exchanges in China and thus have additional disclosure requirements. All of these banks have some foreign owners, but until recently the foreign share in ownership has been small.

Although some JSBs were partly organised to further the objectives of local government, the JSBs do not have the same historical legacy as the SOCBs of having been formed mainly to support the objectives of central planners. The management of these banks has a clearer commitment to shareholder value. Their share of lending has been rising considerably in the past few years. They accounted for 14 per cent of banking assets at the end of 2003. The JSBs have

lower NPLs ratios, better capitalisation and more adequate provisions against NPLs than the SOCBs.

The JSBs have been seeking to introduce innovative products and to upgrade their internal risk management and credit procedures. Many JSBs have relied on international consultants and/or agreements with external partners in order to obtain access to the best international techniques. Among the improvements in credit procedures instated at the JSBs are the requirement for the management to articulate an overall lending strategy and to have written credit policies and procedures. All of the JSBs have now separated loan origination and loan approval and established limits on individual customers as well as regions and industries. JSBs are also developing databases on their lending portfolios. However, databases on consumer credit are not well developed and the JSBs do not have credit scoring models – a tool that has proven effective in minimising loan losses from retail lending in many countries. While some of the SOCBs have been taking similar measures to introduce enhanced credit systems, the JSBs are generally seen to have acted more rapidly and to have advanced farther.

City commercial banks

There are more than 1 000 city commercial banks, which are owned by municipal governments. These banks accounted for about 5 per cent of the total banking sector. They originated in the consolidation of urban credit co-operatives under the guidance of local authorities and are organised as joint stock companies. City commercial banks have been tightly controlled by local government and enterprises, which hold significant shares in the banks and often receive low-interest loans from them. Unlike SOCBs, they have multiple shareholders with representation on the board.

This group is very disparate with widely varying standards of governance. Some of the city commercial banks are simply financing appendages of local governments, but a few of the larger banks have governance structures and business plans that are comparable to those of the joint stock banks.

Rural credit co-operatives (RCCs)

There are 38 000 rural credit co-operatives which collectively account for 10 per cent of total banks assets. With the reform of banking, the SOCBs have largely withdrawn from rural finance. (A partial exception is the ABC which retains a leading role in the rural sector.) As a result, the rural sector has been financed either from government banks, mainly ABC, some local commercial banks and rural credit co-operatives. The RCCs have succeeded in attracting large amounts of deposits but have been unable to expand lending to keep pace with demand, leading to rising dependence on informal money-lenders.

The RCCs have weak governance structures and very weak balance sheets. Indeed, the RCC sector is reportedly the weakest sector in the banking system, with major problems of governance and large stocks of NPLs. The RCC sector is benefiting from government policies that distribute rural credit at subsidised rates, but a more comprehensive long-run reform aimed at strengthening balance sheets in RCCs and improving their governance regimes is advisable.

Renewed efforts to reform the banking system after 2003

Since the 1990s, the authorities have been considering the basic elements that should be included in a transformation of the banking system. These elements included the corporatisation of the banks with the objective of public listing, the adoption of more sophisticated asset classification systems and an enlargement of the independence of the bank *vis-à-vis* local government. Taken as a whole, these reforms signify that the authorities have decided to change the nature of Chinese banking from a relatively opaque system with limited competition and limited foreign presence, where banks were protected by government guarantees, to a system based on more global standards of transparency and competition. Eventually banks should rely less on the protection of government guarantees and more on their own risk management capability.

In 2003, the process of bank reform advanced considerably as the authorities decided to step up attempts to translate these ideas, which had been under debate for more than a decade, into concrete action. The Sixteenth Congress of the Communist Party endorsed accelerated efforts to restructure the banking system. In the light of the limited progress made after the 1998-99 financial injections, it was recognised that attempts to repair the balance sheets by pumping additional funds into the banks would remain ineffective without changing the basic framework of incentives inside which the banks operate.

Future reforms had to address issues such as the ownership of the bank, the incentives of the bank's owners and managers, the market signals which the banks receive and the degree of competition in the market.

Since that time, the authorities have been articulating a doctrine as to how the governance system in banks should change. In the case of the SOCBs, this change will be linked to an attempt to strengthen the banks' balance sheets through additional financial support.

The key elements of the policy are:

1. A reform of ownership structures of banks in order to find owners capable of monitoring bank performance effectively.
2. Upgrading supervisory practices in line with international norms.

3. A strengthening of the legal and regulatory framework for bank governance.
4. Increased transparency and increased exposure of Chinese banks to scrutiny by the market.
5. An expanded foreign presence in the banking system partly linked to Chinese WTO membership and partly linked to a desire to benefit from foreign competition.

These measures apply to all banks. Simultaneously, a special programme is being launched for the SOCB sector, in which two “pilot” SOCBs, BOC and CCB, will be subjected to radical restructuring and in which access to public funds will be conditional upon reforms undertaken by the banks. The programme for the two pilot SOCBs is discussed below.

Reforms in bank supervision

Supervision of banks has been evolving along with the reform of the banking system since the late 1970s. The People's Bank of China (PBC), which functioned as both a lending institution and as the central bank under the central planning system, was designated as the nation's central bank and charged with the functions of all central banks, such as the conduct of monetary policy and lender of last resort, as well as responsibility for all financial supervision. The supervisory responsibilities of the PBC have been progressively diminished, with responsibility for insurance and securities being transferred to specialised bodies during the 1990s. Until 2003, however, bank supervision remained its responsibility.

The PBC had ongoing difficulties in providing effective bank supervision for several reasons. There was an inherent difficulty in supervising banks that still functioned as quasi-governmental agencies. While aware of the need to enforce prudential norms, government officials also responded to other considerations, such as the need to keep enterprises functioning in order to support employment and social benefits. The effectiveness of the PBC as banking regulator was further limited by the fact that local offices reported to the local government as well as to PBC headquarters in Beijing. Since local governments typically supported local enterprises that provided local employment and social services, there was a serious conflict between the PBC role as banking supervisor and its role as an arbitrator of the regional distribution of credit (Cai, 1999).

Despite these problems, the PBC made gradual progress in upgrading banking supervisory practices during the 1990s. Significant strides were made in building capacity and developing supervisory techniques based upon international norms. However, the PBC lacked the means of sanctioning banks that were unable to meeting prudential norms and were protected by local government or party interests. There were problems with the old loan classification system inasmuch as in the past loans were classified under four headings: normal, overdue, idle

(more than 180 days overdue), and bad. Banks were not required to provide for NPLs, although they were required to set aside 1 per cent of assets as a general provision each year. In 1999, the PBC proposed a more rigorous system of loan classification and provisioning. The new system contained five categories with progressively higher requirements for provisions: *i*) pass (1 per cent provisioning requirement); *ii*) special mention (2 per cent); *iii*) substandard (20 per cent); *iv*) doubtful (50 per cent); and *v*) loss (100 per cent). The new system was, in principle, based upon forward-looking criteria and assessments of repayment capability rather than upon delinquency history. While some of the banks experimented with the system, few banks actually adopted it.

With the decision to accelerate banking reform in 2003, supervisory responsibility was transferred to the newly formed China Banking Regulatory Commission (CBRC). This decision reflected the thinking in many advanced countries that the central bank should focus on monetary policy and issues of systemic stability while actual supervision of banking institutions should be performed by a separate entity. At the same time, the PBC as central bank and lender of last resort will have significant responsibility for the soundness of the banking system as a whole.

The CBRC is now attempting to align its domestic activities with best international practices. The CBRC will be more centralised and its local offices will be insulated from local pressures. Three new laws on commercial banking, banking supervision and the PBC were enacted at the end of 2003. A series of directives and rules have been issued, covering a wide-range of issues related to supervision. The CBRC stated its intention of moving from the earlier compliance-based methods of supervision to the newer risk-based system. The five-tier loan classification system previously proposed by the PBC was made mandatory. The CBRC began building institutional capability to conduct on-site and off-site inspections and imposed a large number of sanctions for infractions of rules. The CBRC initiated a self assessment of its own compliance with the Basle Core Principles of Banking Supervision, the recognised global standard for banking supervision, and prepared a medium-term plan for improving compliance.

In February 2004, the authorities introduced a new risk assessment system that will be used in evaluating the JSBs. This system will be similar to the systems used in other markets. Banks will be scored for capital, asset quality, management competence, liquidity and profitability. The system will be used in interacting with the banks senior managers and board.⁶

Since late 2003, the CBRC has been articulating a strategy to reform the banking system based upon accelerated introduction of market-based principles of corporate governance in the banks as well as special programmes to rehabilitate the SOCBs.

Changing patterns of ownership

In the past, the lack of identifiable owners has been one of the reasons that the banks have operated in a systemic vacuum. The authorities have accepted that a different ownership structure for banks is needed to support a sound governance regime and thus are seeking to diversify present ownership patterns.

Investors can be sought for several reasons: i) to bring new capital into the bank; ii) to rectify a deficiency in governance by acting as genuine owners and active monitors; iii) to assist in the transfer of relevant skills into the bank. Various categories of owners can make different contributions to the bank. To find the appropriate mix of new owners is a critical challenge.

Clearly, a large share of equity will be owned by domestic interests. Domestic industrial interests may have some capital to contribute and may regard their investment in the bank as an “arm’s-length” financial investment. Moreover, given the lack of a strong domestic institutional investor community, they may represent the category of domestic investor that is best able to act as a monitor. Most of the JSBs, the category of domestic bank most focused on shareholder value, have large investments from domestic industry. However, a very large presence in bank ownership raises the possibility that the industrial companies will seek to use the bank for connected lending. On balance, the possibility of conflicts of interest between banking and industrial interests suggests that such ownership linkages should be limited.

Domestic retail and institutional investors are an additional source of new owners, and there will be significant domestic ownership of banks by dispersed groups of Chinese investors. With large numbers of Chinese citizens holding sizeable stakes in the banks, a definable constituency should emerge for sound banking practices that will give boards and management a strong incentive to produce competitive returns and to avoid action that would result in diminution or loss of value of shareholders equity. On the negative side, neither domestic retail investors nor institutional investors have historically shown strong capabilities or inclination to monitor companies in which they are shareholders, and neither has tended to place pressure on the corporate sector to raise standards of transparency and disclosure or to respect the rights of minority investors. At this time, the Chinese capital market does not have a strong infrastructure of rating agencies and securities analysts who will engage in rigorous analysis, demand higher standards of performance and disclosure from companies. On the other hand, domestic investors will clearly benefit if the degree of professionalism in the Chinese investment market increases as a result of better governance standards and a more active presence by foreign investors. On balance, domestic portfolio investors can help improve bank performance, but they are likely to be most effective if

they act in partnership with other kinds of investors. In any case, the enhancement of the monitoring capability of domestic institutional investors should be a long-term objective of the authorities, not only for the banking sector but throughout the entire capital market.

Foreign investors can plainly contribute to the improvement of governance in banks, and the Chinese authorities have decided that increased foreign presence will help to effect the desired transformation of the banking system. Foreign equity investors will demand better disclosure and will measure the performance of Chinese banks by the same criteria that other companies are measured. To the degree that foreign equity investors cannot be convinced that Chinese banks are producing value for investors, the share price will decline. Moreover, the listing of Chinese banks on overseas stock exchanges will oblige banks to observe stock exchange rules about disclosure organisation, governance and investor protection, which are more rigorous than in the domestic market.

Foreign strategic investors can make a sizeable contribution to the transformation of the banking sector. Foreign strategic investors are likely to be major banks from major OECD member countries or other financial centres that have developed significant banking-related skills in areas such as credit assessment and risk control, and they are likely to have state-of-the-art knowledge in banking. Such skills are abundant in the major, more advanced countries of the world but are still relatively scarce in many emerging markets. Many banks have developed strategies of expansion to key emerging markets where banking skill is less abundant. The pattern of bank rehabilitation making use of foreign strategic partners has been the basis for successful rehabilitation of banks in Central Europe, some Latin American countries and in the Republic of Korea.

China offers huge attractions to foreign banks pursuing global expansion strategies because of the size of the market, the high levels of savings and the low current levels of products and services. For example, the Chinese consumer and mortgage markets are largely underdeveloped, and skills in assessing the credit-worthiness of smaller and private enterprises are not well developed. These activities are currently being financed through parallel markets that could be made highly profitable if they were brought within the formal financial system. Foreign banks would thus have an opportunity to have strategic investment in Chinese banks that would have the potential to grow as the bank moves toward global levels of competence.

At this time, the effort to change ownership structures is focused on two categories of banks: i) the joint stock banks where the ownership/governance structure is already more favourable than in the remainder of the banking system; and ii) the two pilot SOCBs which aim to transform their ownership structures as part of the reform.

The JSBs are in the process of broadening their ownership structures. The JSBs have already been gaining a significant market share and now have an opportunity to expand their share of the banking market yet further. In order to gain market share, however, it will be necessary to increase their capital without recourse to official support. The JSBs have been increasing their assets rapidly, so their capital adequacy ratios are consequently only marginally sufficient.⁷ The JSBs will seek to raise their capital by: i) public equity issues on domestic or international exchanges, including rights issues; ii) issues of subordinated debt; and/or iii) strategic partnerships with foreign banks. At this time only five banks are publicly listed, but further domestic and international listings are expected.

Several JSBs have already included foreign entities such as Citibank, Hang Seng Bank, the IFC or the ADB as strategic investors, but thus far their positions have been rather small. Under the WTO rules accepted by China, foreign institutions will be authorised to own as much as 20 per cent of total bank capital, with the share scheduled to rise to 49 per cent in 2007.

There have been several highly publicised cases of large-scale foreign strategic acquisitions in recent months. In May 2004, Newbridge Capital, a US-based private equity firm that has a record of successful turnarounds of banks in other Asian countries, bought a 19 per cent stake in Shenzhen Development Bank. In July 2004, the Hong Kong and Shanghai Banking Corporation (HSBC) announced its intent to acquire 19 per cent of the Bank of Communications, the largest JSB in the country. This investment will give HSBC access to a network of 2 700 branches in 139 cities and a customer base. It may well set a pattern for other banks seeking to enter the Chinese market. The HSBC investment follows an increase in capital provided by the Chinese bank's existing shareholders and is also expected to lead to an overseas listing in the next two to three years. With increased capital and with increased transfer of foreign banking skills, the JSBs will aim to expand their market share further. The inclusion of foreign investors in the ownership structure is likely to facilitate the transfer of skills, the upgrading of risk controls and closer alignment of governance practices in the Chinese banking system with those in global markets. In fact, in some investment agreements, specific provisions are made for the foreign partner to devote resources to building up skills in the Chinese partner, usually in areas such as risk management, consumer finance or marketing.

Since there are only a limited number of opportunities for strategic partnership with JSBs, there may be some possibilities to forge partnerships with city commercial banks as well, especially some of the larger banks with a more commercial orientation. A few alliances of this kind have already been launched and more are reportedly under consideration.⁸

At the same time, many major international banks have strong reservations about participating as small minority investors in the SOCBs. This represents a

major challenge for the authorities in implementing a change in ownership of the SOCBs in order to effect an improvement in bank governance.

Improving the framework for corporate governance in banking

The authorities have been seeking to improve the corporate governance framework, both for banks and for the non-financial corporate sector, during the past decade. Many laws, regulations, codes and standards necessary for a complete system of governance have been enacted. Efforts have been undertaken to ensure that those who will hold key positions under the new governance framework have sufficient training and experience. Simultaneously, enforcement efforts have been stepped up.

The legal and regulatory framework governance is not identical for commercial banks and for non-financial enterprises. Some instruments, such as the Company Law, are binding on banks and non-banks alike, so long as the entity is organised in the corporate form. State-owned enterprises (SOEs), other than banks, are also subject to an additional instrument.⁹ On the other hand, banks are subject to several special laws and other instruments that create more stringent obligations than those applied to SOEs.

The main instruments affecting the corporate governance framework for banks are: i) the Company Law; ii) the Banking Law; iii) the Law on Banking Supervision;¹⁰ iv) the Guidance on Corporate Governance for Joint Stock Commercial Banks; and v) the Code of Corporate Governance for Listed Companies (CCGLC).¹¹ The Company Law and the CCGLC apply to financial and non financial companies, but the other instruments only apply to banks. The CCGLC applies only to publicly listed companies, *i.e.* five JSBs, but a growing number of banks are expected to be listed eventually. As will be explained below, the two pilot commercial banks are subject to additional instruments.

The Company Law stipulates that all SOEs must have a board of directors with a chairman and vice chairman, and a general manager. The general manager, who is accountable to the board, may also be a member of the board. The Law limits the size of the board for a joint stock company to between five and 19 members. In addition, the Company Law also specifies the responsibilities of boards, which are generally in line with those accepted in international practice, but the Law does not provide board members with clear guidance on how they are to exercise their responsibilities.

The Banking Law of 1994, amended in 2003, contains many provisions concerning the corporate governance of banks such as the role of various organs of the company and the requirements regarding transparency and disclosure.

A number of laws and regulations impose further requirements on banks. In 2002, the PBC issued Guidance for Joint Stock Banks (the Guidance) which is aimed at giving more precise guidance to banks over and above the obligations specified in the Company Law and the Banking Law. This document specifies the framework for decision-making inside the bank, with specific roles with necessary checks and balances for the shareholders meeting, the board of directors, the board of supervisors and senior management and also stipulates that banks have an obligation to establish an adequate system of reporting and disclosure. These requirements go beyond those in the Company Law. One of the aims of the Guidance is to define means to protect the interests of shareholders and depositors and specifically establishes an obligation on the part of controlling shareholders to respect the rights of noncontrolling shareholders and depositors. The obligation of directors to defend these interests is specified. Various prohibitions are established regarding related party transactions.

In order to promote the effectiveness of the board as an independent check on management, various persons having borrowing relationships with the bank are disqualified from serving as directors. The directors of banks have the right to obtain all information needed to monitor the operations and financial situation of the bank. Executive directors shall constitute between a quarter and one-third of all directors. In addition to non-executive directors, the board must have fully independent directors, *i.e.* those with no relationship to the bank or its shareholders that may raise conflicts of interest. Independent directors are specifically mandated to take into account the interests of smaller shareholders and depositors. Independent directors also have the duty to report any violations of laws or regulations to the banking supervisor.

There are some ambiguities concerning the concept of independent directors. In general, the term “independent directors” is used to mean a non-executive director, *i.e.* someone who is not an employee of the company. There is another definition of independent meaning free from other connections to the company and conflicts of interest arising from those connections. The connections may be personal (*i.e.* individuals having personal or family ties to the company or its executives), or they may be commercial (*i.e.* those affiliated with an entity that deals with the bank), thus posing the risk of conflict of interest. However, there has been some tendency in China to nominate fully independent directors, usually from universities or professions such as law and accounting.

One of the obligations of the board of directors is to disclose the assessments by the banking supervisors and in cases where remedial action is mandated to describe plans to correct shortcomings. The Guidance also mandates the separation of the chairman and the CEO of the bank, and the board is required to establish specialised committees including Related Party Transactions Control, Risk Management, and Remuneration.

The CCGLC further stipulates that the audit committee, the nomination committee and the remuneration and appraisal committee shall be chaired by an independent director, and independent directors shall constitute the majority of these committees. At least one independent director from the audit committee shall be an accounting professional. The main duties of the corporate strategy committee are to conduct research and make recommendations on the long-term strategic development plans and major investment decisions of the company.

Under the Guidance and under Chinese practice generally, the audit process is somewhat different than is generally recommended in international practice. The Guidance does not require the board to form an audit committee, and it also specifies that the internal audit report to the president of the bank rather than the board. Instead, the audit procedure is closely linked to the supervisory board which plays a distinct role in Chinese companies. The Bank Guidance also gives the senior management relatively strong protection from interference from the board and strongly discourages the board from replacing the senior management before the expiration of their term.

It is specified that the banks shall comply with disclosure requirements of the supervisor, but the specific items that must be disclosed are not spelled out. One of the obligations of the board of directors is to disclose the assessments by the banking supervisors in cases where remedial action is mandated and to describe plans to correct shortcomings.

Like all Chinese companies, banks are required to have a board of supervisors. Unlike the supervisory board in systems with two-tier board systems, the Chinese board of supervisors does not form part of the governance hierarchy. The board of supervisors is an entity that operates outside the decision-making hierarchy and with the function of overseeing compliance with laws and regulations. The supervisory board is composed of outside supervisors appointed by the state as well as some representatives of the workers. The supervisory board is responsible for: *i)* monitoring compliance of the company with laws, regulations and rules; *ii)* examination of the financial statements of the SOE; *iii)* inspection of business performance; and *iv)* evaluation of the CEO. The supervisory board engages the outside auditor. An audit is performed at least once a year and when the CEO changes. The supervisory board reports to the president and presents its finding to the shareholder meeting. Many analysts have argued that the board of supervisors does not represent an effective contribution to a set of checks and balances needed to establish clear lines of accountability from management to board to shareholder. In this context it has frequently been recommended that the role of the board of supervisors be re-evaluated as part of the general effort to align Chinese and international practices.

Overall, the basic set of instruments that form the governance framework for banks are in line with those in other countries. Given China's limited experience of the use of market-based governance tools, it would be desirable to devote significant resources to deepening understanding among those who will play significantly expanded roles under the new governance regime. For example, written guidance concerning the duties of bank directors would be helpful. This could be part of a general code of conduct for company directors or more specifically directed at bank directors. Many countries have such codes which may be formulated by the regulatory authorities, self-regulatory organisations, or by individual companies. Institutes of directors, which often engage in training for directors, often assist in formulating such codes and in promoting their use. Finally, difficulties in enforcement of laws and regulations remain a serious obstacle to improved corporate governance in China.

Since only a few banks have been corporatised and even fewer have been listed, for the most part banks have not been obliged to operate inside the formal corporate governance framework in China. At the same time, it is widely agreed that corporate governance in China needs to move closer to world standards. Specifically, it is generally agreed that corporatisation and public listing have not succeeded in improving the financial performance of listed Chinese companies and has not obliged listed companies to pursue shareholder value as an overriding corporate objective. Therefore, the goal of improving bank governance by subjecting Chinese banks to the same corporate governance framework to which listed Chinese companies are already subjected can only succeed if that framework itself improves significantly. To some degree the banking supervisors can impose stricter practices on Chinese banks than are imposed on other corporate entities. Thus, banking supervisors can be stricter regarding disclosure than is required by stock exchange rules for listed companies and the supervisors can require each bank to bring its system of corporate governance up to minimal norms. However, the entire system of corporate governance in China will have to improve in order for the policy of requiring banks to operate in the corporate governance for listed companies to have its intended effect.

Transparency and exposure to markets

Under the new governance environment, banks will be required to observe far higher standards of transparency and will be subject to much more intense market oversight than in the past. Banks will be scrutinised by other banks, both domestic and foreign, be subjected to more intense coverage by the financial press and constant scrutiny of the capital market. As Chinese banks seek to raise capital through equity and subordinated debt issues, many foreign investment banks are undertaking analyses of the Chinese banking system and making recommendations concerning equity investments. In order to meet the expectations of

new investors, Chinese banks will have to increase the quantity and quality of data disclosed and also to perform in line with market expectations. The CCGLC will add further disclosure requirements, and those banks that list on foreign stock exchanges will be subjected to additional requirements.

In addition to assessments by equity markets, the debt and interbank markets will place Chinese institutions under growing scrutiny. At this time, credit-rating agencies rely heavily on official guarantees in assigning ratings to Chinese banks, but as relationships become more complex, banks that can establish credibility with rating agencies and counterparties based upon their own financial strength will gain competitive advantage. In addition, Chinese banks will be engaging in an increasingly complex range of operations with foreign institutions. Each Chinese institution will have to take pains to convince prospective counterparties of its creditworthiness. On the strength of these ratings and their own assessments, investors and other financial institutions will be deciding whether, and at what cost, they are prepared to engage in various kinds of operations with Chinese intermediaries. The decision to accept market discipline means that in the long run the banks will be under growing pressure to persevere in restructuring. Thus, in order to raise new capital while borrowing on competitive terms, banks will have to meet market expectations by raising earnings to competitive levels, to bring costs under control and to reduce NPLs. The pressure from the market to make progress on these indicators will supplement the pressures from the banks' directors and from the banking supervisors.

Expanded foreign competition

As noted above, the foreign presence in the market will expand as a result of foreign participation in the equity of Chinese banks. Foreign participation in the market will also expand as the scope for foreign banks to compete directly in the domestic market through branches and subsidiaries increases and as foreign banks gain greater access to domestic currency operations. Previously, China imposed strict limitations on the operations that foreign banks could undertake and particularly limited operations in domestic currency. Largely as a result of these restrictions, foreign banks accounted for only 1 per cent of total banking assets at the end of 2003. Most foreign banks operated in a few large cities and confined themselves to foreign currency loans, mainly to foreign businesses. With liberalisation, this share is expected to grow significantly. By the end of 2006, all geographic restrictions on operations in Chinese currency will be lifted.

The Chinese authorities are unlikely to open their market to the same extent that countries in Latin American and Central Europe did when dealing with failed banking systems. In many of those cases the majority of capital in domestic banks eventually passed into the hands of foreign banks. First, the Chinese, with their

huge stock of domestic savings, do not need foreign resources to recapitalise their banks. Second, the Chinese authorities are undoubtedly not prepared to accept such a degree of foreign ownership at this time. Nevertheless, the opening to foreign competition, through ownership in Chinese institutions, foreign-controlled branches and subsidiaries through cross border competition, has to be significant enough for foreign competition to have a visible impact on the Chinese market.

The experience of the Republic of Korea may be of relevance for China. Until the 1997 crisis, the Korean authorities limited foreign equity participation in Korean banks to very small amounts. At the same time, foreign bank branches and representative offices were restricted to a narrow range of activities which differed significantly from those permitted to Korean banks. After the 1997 crisis, the Koreans opened their banking system and encouraged foreign investors to acquire sizeable strategic positions in domestic banks with the objective of improving the governance of banks. Simultaneously, the authorities removed remaining capital controls and moved toward a policy of national treatment regarding foreign banks. While the foreign presence in the banking system was measured, it was markedly larger than in the years before 1997. The decision to accept an enlarged foreign presence was instrumental in effecting the improvement in bank governance and the successful restructuring of the banking system in ensuing years.¹²

Rehabilitation programme for the SOCBs

The preceding section discussed the framework for corporate governance of all banks that are organised in the corporate form. While most of the reform measures currently being implemented will apply to the SOCBs, the authorities have decided to concentrate reform efforts on two “pilot banks” the China Construction Bank (CCB) and the Bank of China (BOC). Based upon experience in rehabilitating these two target institutions, the programme may be extended or modified in coming years. The programme involves both the commitment of significant sums of money and an effort to change the incentives and governance systems in the banks.

In March 2004, the CBRC issued guidelines explaining their strategy for the BOC and CCB.¹³ These Guidelines were the first concrete steps in a policy designed to produce a significant change in the two pilot banks by the end of 2007. Within that time frame, the banks are expected to operate profitably while maintaining adequate capitalisation, good internal controls, sound business operations and high quality services. In order to strengthen the balance sheets of the pilot banks, some USD 45 billion equivalent of resources from the country's international reserves was injected into these banks (USD 22.5 billion for each bank). The banks are expected to dispose of remaining NPLs through provisioning

or through sale at a discount to face value to the AMCs. In June 2004 the pilot banks sold an additional RMB 279 billion (USD 34 billion) of NPLs to the AMCs. These two banks have also been engaging in sales of NPLs to foreign investment banks.

Projected ownership changes

The lack of identifiable owners and the resulting lack of a commitment to the shareholders are at the heart of the governance vacuum in the SOCBs. Unlike the JSBs, which are already operating as independent banks, the SOCBs were still not separated from the state in early 2004. The first step in changing the ownership structure was taken in December 2003 when a special state entity, the Central Huijin Investment Company (Huijin), was set up to assume formal ownership of the SOCBs.¹⁴ Huijin will operate under a Task Force for Pilot Joint Stock Reforms of State Owned Banks under the State Council. To some degree, the position of Huijin is comparable to that of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) which has the mission of assuming the role of state ownership of SOEs and promoting governance reform in the non-financial sector (see Chapter 10).

While there will be additional owners for the SOCBs, Huijin is likely act as the majority owner for the foreseeable future. Huijin will have the task of representing the state's ownership interest. The state's supervisory interest in the banks will be represented by the CBRC while it is hoped that the government will pursue its regional, social and industrial policy objectives using traditional tools such as tax and expenditure policy.

The ownership transformation process is expected to pass through three stages:

1. Corporatisation. In August-September 2004, the banks were transformed into joint stock companies with the state as the sole owner.
2. Ownership Diversification. While the state acting through Huijin will remain the majority owner, other entities will become owners of minority stakes.
3. Public Listing. The banks will be listed on domestic and international exchanges.

At this stage, the state has no intention of relinquishing its controlling interest in the SOCBs. Most OECD member countries and most non-members with dynamic financial sectors have eventually decided to privatise their banks. One of the basic uncertainties overhanging the reform is whether the SOCBs can be transformed into profit-oriented entities while a commanding share of bank capital remains under the control of the state.

As noted above, domestic industrial interest or portfolio investors do not have a strong history of effectively monitoring investments in pursuit of shareholder value. Nevertheless, it is useful to give domestic investors experience in monitoring investments alongside international investors. Moreover, the commitment of savings by domestic retail investors and institutions will build a constituency in favour of pursuit of shareholder value by management.

It is part of the official strategy of the Chinese authorities to solicit participation by foreign banks as strategic partners in the SOCBs. Chinese policy makers insist that they are not seeking investment by foreign banks in order to obtain capital – which is comparatively abundant in China. Rather they are seeking to gain access to the monitoring capability and banking techniques of foreign banks.

There are reasons why foreign banks may hesitate to become strategic partners in SOCBs. In particular, even for banks that are committed to expanding in the Chinese market, many banks would find other means of entering the market, such as ownership stakes in JSBs or expansion of branch or subsidiary networks to be more appealing. Foreign banks are likely to be wary of a strategic partnership with SOCBs where the lack of history of operation as a profit-making entity represents a heavy burden. Furthermore, the SOCBs face a long period of restructuring and down-sizing, and are saddled with a large stock of NPLs. Foreign banks may well hesitate to be drawn into visible positions as strategic investors in which they will suffer the risk of financial loss and loss of reputation but over which they can exercise little control. Foreign banks may only be willing to take a minority position in order to promote their business with the SOCB in a specific area (*e.g.* credit cards), or to gain official support for their expansion into other, more lucrative areas of the banking sector through branches, strategic alliances or cross-border operations. Thus, the commitment of the foreign partners to improve governance may not be sufficient to produce the needed changes. On balance, foreign strategic investors are vital to the success of the effort to rehabilitate the SOCBs, but the authorities face an uphill struggle in persuading foreign institutions to participate as minority strategic partners.

Many market participants believe that the two pilot banks will seek to be publicly listed in 2005 and both banks are keen to achieve listing, but no deadline has been set for public listing.

Internal governance of the pilot SOCBs

The authorities aim to transform the SOCBs into entities that have a distinct legal identity with identifiable owners who have a stake in the financial performance of the bank while building governance structures designed to protect the interests of the owners. By assuming the corporate form, the pilot banks will become subject to the Company Law and the Bank Guidance as well as the spe-

cific measures aimed at the pilot banks. Overall, these instruments require the formation of a shareholder committee, board of directors, supervisory board and executive management with established functions for each organ. The two pilot banks are expected to find domestic and international strategic investors to assume ownership positions in the banks and to nominate directors and to take part in meetings of the shareholder committees. Huijin will nominate directors to represent the state's interest as an investor. Presumably these directors will include both those having very close ties to the government as well as some fully independent directors. The exact modalities by which Huijin will represent the state's interest are still under discussion.

The pilot banks will be expected to articulate strategies to achieve business targets and to set annual targets while assessing progress in meeting these targets. In order to be able to meet these targets, systems of human resource management are to be revamped. A quantitatively-based system to evaluate management performance is to be instituted and reported quarterly to the banking authorities.

The banks will have greater freedom in choosing their own management and in implementing personnel policy. In July 2004, the two banks each named their CEOs who will be separate from the chairmen of the bank. CCB chose an outsider who had been vice-chairman of a major financial institution controlled by the government, while BOC chose a governor of a province.¹⁵ Moreover, both banks are engaging foreign consulting firms in upgrading skills such as risk management.¹⁶ Beginning in 2004, the pilot banks applied the CBRC five category loan classification system to their entire portfolios including their off balance sheet items.

The pilot banks are expected to meet specified targets for the most commonly used benchmarks for earnings and balance sheet quality. In particular, return on assets should rise to 60 basis points by the end of 2005 and subsequently to internationally competitive levels. Return on equity should rise to 11 per cent by the end of 2005 and to at least 13 per cent by 2007. The cost-income ratio should be held within a range of 35-45 per cent. At all times the capital adequacy ratio shall be at least 8 per cent.¹⁷ NPLs will be held in the range of 3-5 per cent. The pilot banks are expected to make continued progress in resolving NPLs and to identify any irregularities that occurred during the process under which loans became delinquent. By the end of 2005, provisions for NPLs shall be increased to 60 per cent for the BOC and 80 per cent for CCB.

The CBRC will evaluate progress in implementing corporate governance reforms and in improving financial indicators, through inspections and surveillance reports. The results of these reports will be transmitted to the Task Force for Pilot Joint Stock Reforms of State Owned Banks under the State Council.

Summary and conclusions

Banking in China is now entering a new historical phase. Following the decision to launch the economic reform in 1978, the authorities have been seeking to redefine the role of the banking system from its passive position under the old system of central planning to an active position in credit and resource allocation. The changes over the years have included the separation of the central bank from commercial banks, as well as a series of measures designed to encourage banks to act as independent monitors over the enterprise sector.

Through the late 1990s, the results were disappointing. The banks, particularly the state-owned commercial banks, lacked the identity of independent profit-seeking entities. Thus, the management continued to operate the banks as appendages of the government and continued to subordinate the financial soundness of the banks to a variety of political, social and economic considerations. Easy access to bank credit removed the incentives for enterprises to take action to become more efficient. One of the results of this adverse credit selection was very poor quality in bank balance sheets. Even with the commitment of significant resources to strengthen bank balance sheets in 1998-99, banks persisted in their earlier patterns of behaviour.

Observing the unsatisfactory results of these earlier efforts, the authorities concluded that any further use of public resources to strengthen bank balance sheets had to be linked to improvement in the governance regime of the banks. Following the decision at the 2003 Party Congress to press ahead with banking reform, the authorities introduced the most ambitious set of reform plans undertaken to date. The specific measures that were included in the programme had been under discussion for several years. Nevertheless, taken as a whole, the programme represented the most serious effort to date to change the behaviour patterns of banks. The key elements of the reform are:

1. a reform of ownership structures of banks in order to find owners capable of monitoring bank performance effectively;
2. upgrading banking of supervisory practices in line with international norms;
3. a strengthening of the legal and regulatory framework for bank governance;
4. increased transparency and increased exposure of Chinese banks to scrutiny by the market;
5. an expanded foreign presence in the banking system partly linked to Chinese WTO membership and partly linked to a desire to benefit from foreign competition.

In addition to these measures that will affect all banks, the authorities have committed USD 45 billion to support financial restructuring in two “pilot” state-owned commercial banks, contingent upon the implementation of governance reform by these banks.

The reform programme, which is very bold in its aspirations, reflects a striking willingness on the part of the Chinese authorities to relinquish direct control over banks and to allow the banks to be subjected to market pressures. Previously, the Chinese banking system operated under a system that was under the close control of the authorities and where efforts were made to minimise the influence of the global financial market on China. This set of policy changes represents a significant narrowing of the differences between the Chinese banking system and the world banking system.

The new policy postulates that, with ownership and governance changes, the boards and management of the banks will have to respond to the interests of their owners rather than act as agents of state policy. The enlarged flexibility to select and remunerate their managers should increase their independence. By encouraging stock exchange listing and enhanced transparency, the banks should ultimately rely less upon the guarantees of the government and more on their own standing with the market. Banks will be under great pressure to meet the expectations of financial markets, especially as they will be seeking to raise large sums in the capital markets both domestically and internationally.

While the present policy is the boldest introduced since the beginning of reforms two decades ago, there are still limits to the moves that the authorities have been willing to make. In the first place, the projected reform covers only the two smallest SOCBs and to a lesser degree the JSBs. This study, which is focused on governance issues, has concentrated on those sectors where governance reforms are expected to be centred. Other categories of lending institutions, such as the remaining SOCBs, the city commercial banks, and the rural credit co-operatives (RCCs), where the problems of solvency are more acute, are not targeted for reform at this time, but their problems may well continue to grow, even if some progress is made in the targeted groups of banks.

With respect to the two pilot SOCBs it is not obvious that the planned change in ownership structure, in which the state will retain its controlling share indefinitely, represents a viable model for governance. Additionally, if prospective foreign strategic partners are restricted to very small holdings, it is uncertain whether they will be interested in participating or whether their participation can be effective under these conditions. Furthermore, the SOCBs are extremely large and indeed they may be so large that they produce diseconomies of scale, particularly for banks that are only marginally solvent and that are troubled by serious flaws in governance.

It is not possible to foresee how the banking reform will proceed. For example, if the efforts to reform the “pilot” banks are encouraging, the programme might be extended to other SOCBs. Conversely, if the results are unsatisfactory, the authorities may have to consider more drastic measures, such as breaking up the state-owned banks or simply closing them.

Given the country's history of partial economic reforms and the lack of depth in the legal and institutional infrastructure, the problems to be overcome are formidable. The country lacks a cadre of experienced corporate directors and guidelines for directors are unclear. Public listing thus far has generally not led to markedly improved performance for Chinese companies. Therefore, the effect of market discipline will be felt only if improvements in the entire framework for corporate governance, for financial and non-financial companies, are made. Despite all the uncertainties, it is clear that, given the magnitude of the changes already introduced and those to be introduced shortly, there is no serious option of reverting to the old patterns of behaviour, especially since the reform is taking place in the full view of the Chinese population and the international financial community.

Although there are serious questions of whether the reform will succeed in its present form, there are some recommendations that can be made to maximise the chances for success. Many of the recommendations for improved bank governance are similar to those that would be made for the entire corporate sector. Some of the more salient of these recommendations concerning the corporate governance of JSBs and pilot SOCBs are:

1. Domestic industry will be permitted to have some ownership stakes in the pilot SOCBs. In view of the potential conflicts of interest between banking and industrial interests, such ownership linkages should be limited.
2. Foreign banks should be allowed to expand their presence in the market to the extent that they provide serious competition to domestic institutions.
3. Efforts should be enhanced to develop adequate regulatory frameworks for institutional investors and to enhance the capability of domestic institutions to act as monitors for the corporate sector.
4. The role and responsibilities of independent directors should be clarified. Codes of conduct for directors and specialised training have been used in other countries.
5. The means whereby Huijin will exercise the ownership rights of the state should be clarified and aligned with international practice.
6. Special programmes tailored to the needs of bank directors should be considered.

7. The Guidance on Corporate Governance for Joint Stock Commercial Banks of 2002 should be reviewed to assure that it adequately covers the situation of the pilot SOCBs.
8. The authorities should study the effectiveness of boards of supervisors in the context of corporate governance to determine whether fundamental changes are needed.

Notes

1. The international standard for corporate governance of both financial and non-financial companies is the OECD's Principles of Corporate Governance.
2. In addition to the traditional credit risk that banks have historically assumed, many banks are now becoming involved in innovative transactions that involve other kinds of risk, such as market risk and exchange rate risk. Additionally, as banks began to engage in longer term, over-the-counter operations, often in unfamiliar products, counterparty risk, liquidity risk, settlement risk and legal risk assume greater significance. A complete risk management system requires that the bank develop adequate systems to identify each one of these risks and to quantify the amount of risk that is undertaken in each transaction. A strong internal compliance function should assure that all policy areas actually being implemented. The Risk Management committee of the Board typically approves the risk policies of the bank and seeks to ascertain that systems to ensure compliance are adequate.
3. In addition to characteristics stemming from China's history as a centrally planned economy, the Chinese financial system shares many characteristics with those of other Asian countries. In many Asian countries financial resources were not allocated on market-based criteria. Instead, the assets held by banks and other financial institutions tended to be used by governments, allied industrial groups and other well connected groups to further national industrial and social policy objectives. As a result, there was a subordination of prudential considerations to the interests of the banks' controlling shareholders and to the aims of national industrial policy. Consequently, financial supervisors did not attain the independence or the technical capacity to pose a counterweight to the pressures of industrial ministries within the decision-making structure. After the 1997 crisis exposed the risks of this pattern of intermediation, most Asian countries have identified the need to build capacity in financial supervisors and to change the governance regimes of financial institutions as a key task in their reform effort. China has followed this general pattern.
4. The assets that were removed from the balance sheets of the banks were transferred to four state asset management companies (AMCs) which had the mission of resolving the impaired assets of banks and recovering value from imparted assets. These AMCs were modelled on similar institutions that were formed in the Asian crisis countries to purchase impaired assets from banks, thereby allowing banks to concentrate energy on improvements in the institutions. Meanwhile the AMCs were expected to focus on recovery of value from impaired assets. The four AMCs in China have made less progress in loan recovery than many of their counterparts in other Asian countries such as Korea or Malaysia.

5. For some useful insights, see “Building a Transparent Private Bank in China”, *China Daily*, 23 February 2004.
6. “The CBRC introduces a Provisional Risk Assessment System for Joint-Stock Commercial Banks”, *China Daily*, 22 February 2004. Also see: “New Banking Risk System Lauded”, *China Daily*, 23 February 2004.
7. According to analyses of Morgan Stanley, the tier one capital as a share of assets of the four listed JSBs is the lowest of any group of banks in the East Asia region.
8. For example, the Bank of Shanghai has formed an alliance with Citibank with equity participation, while the Nanjing City Commercial Bank has a similar agreement with the IFC.
9. Interim Regulations on Supervision and Management of State-Owned Assets of Enterprises, 27 May 2003.
10. *Law of the People's Republic of China on Banking Regulation and Supervision*, 27 December 2003.
11. *The Code of Corporate Governance for Listed Companies of the CSRC and the State Economic and Trade Commission*, 7 January 2001.
12. See OECD (1999).
13. CBRC, *Guidelines on Corporate Governance Reforms and Supervision of Bank of China and Construction Bank of China*, 11 March 2004.
14. Several options for the ownership transformation were considered such as forming a Committee under the State Council with the responsibility for bank rehabilitation, transferring ownership to the CBRC or creating a special bank rehabilitation agency with a limited life.
15. “China Moves to Improve Bank Boards”, *Financial Times*, 29 July 2004.
16. “Bank of China Grooms Itself for Public Offer”, *Wall Street Journal*, 30 March 2004.
17. Although 8 per cent is the international standard, the banking supervisors in other Asian emerging economies are now setting higher standards for their domestic banks.

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Résumé : La gouvernance des banques en Chine

Avec les réformes économiques de la fin des années 70, la politique des autorités chinoises s'est fixé pour objectif d'amener les banques du pays à abandonner leur rôle traditionnel passif consistant à exécuter les directives adoptées à un rôle actif dans l'allocation des ressources bancaires dans une économie de marché. Toutefois, en raison d'un régime de propriété peu transparent et de leurs antécédents en matière de soutien à la politique régionale et industrielle, la plupart des banques chinoises ont eu du mal à effectuer cette transition. C'est particulièrement vrai des quatre grandes banques commerciales d'État qui représentent la majeure partie des actifs bancaires et qui ont toujours fonctionné comme des prolongements de l'administration publique. En revanche, la deuxième grande catégorie de banque, les 11 banques par actions affichent des bénéfices plus importants et des bilans de meilleure qualité. En 1998-99, des efforts importants ont été consentis pour renforcer les bilans des banques commerciales d'État avec la vente subventionnée d'une grande partie de leurs créances non productives à des sociétés de gestion des actifs publics, mais les résultats ont été décevants. Lors de la toute récente phase des réformes qui a commencé en 2003, les autorités sont parvenues à la conclusion que les tentatives futures de redressement des banques commerciales d'État devaient s'attaquer à la question de leur gouvernance.

Les principaux éléments de cette récente phase de réformes lancée en 2003 résident dans la diversification de l'actionnariat, l'introduction en bourse et le développement de la présence étrangère en vue de soumettre l'ensemble des banques à des normes plus rigoureuses de transparence et de communication financière, les contreparties des banques, les analystes financiers, les investisseurs institutionnels et les agences de notation étant amenés à exercer une surveillance plus intense des établissements de crédit. Parallèlement, l'application de mesures destinées à améliorer le contrôle des banques a été accélérée avec la création d'une autorité indépendante spécialisée de contrôle des banques (la Commission de réglementation bancaire de Chine ou CRBC) et la promulgation d'une série de lois concernant le contrôle bancaire.

En décembre 2003, une entité spéciale (*Huijin*) a été mise en place pour prendre en charge les intérêts de l'État actionnaire dans les banques commerciales d'État. Deux banques commerciales « pilotes » vont dans un premier temps être transformées en sociétés par actions dont l'État sera l'unique actionnaire et elles bénéficieront d'injections de liquidités pour porter leur capital à des niveaux convenables et constituer des provisions pour leurs créances non productives. Les banques pilotes sont censées trouver des investisseurs stratégiques nationaux et internationaux pour prendre des participations à leur capital et jouer un rôle actif dans leur gouvernement d'entreprise, *Huijin* représentant pour sa part les intérêts de l'État. Une intensification de la concurrence va pouvoir se faire entre les banques commerciales d'État et les autres catégories de banques du pays. Les banques par actions, qui ont déjà conquis des parts du marché ces dernières années, ont là une occasion de progresser encore, en faisant appel à des capitaux nationaux et étrangers. Cela devrait entraîner des modifications des structures actionnariales et intensifier la surveillance exercée par le marché dans le cas des banques par actions.

Ce programme est certes audacieux, mais on peut éprouver des doutes quant à la façon dont va se dérouler la restructuration des banques. De façon générale, la diversification de l'actionnariat et les introductions en bourse n'ont jusqu'ici pas sensiblement amélioré les performances des sociétés chinoises et leur impact sur les banques est donc incertain. Malgré ces incertitudes, les changements déjà introduits ont une telle ampleur qu'il n'est pas sérieusement envisageable de revenir aux anciens modes de comportement.

Cet article a aussi été publié dans l'ouvrage *La Chine dans l'économie mondiale – la gouvernance en Chine* (OCDE, Paris, 2005), étude entreprise dans le cadre du programme de dialogue et de coopération entre l'OCDE et la Chine.

Abstract: Improving Financial Literacy: Analysis of Issues and Policies

In 2003, the OECD established the Financial Education Project in response to the increasing interest of its member countries in improving the financial literacy of their consumers. Phase one of this project has culminated in the publication of the first major study of financial education at the international level. This book, *Improving Financial Literacy: Analysis of Issues and Policies* (OECD, 2005, forthcoming), contributes to the development of consumer financial literacy by providing information to policymakers on effective financial education programmes and by facilitating the sharing of experience in the field of financial education and awareness.

The book identifies and analyses financial literacy surveys in member countries, highlights the economic, demographic and policy changes that make financial education increasingly important, and describes the different types of financial education programmes currently being offered in OECD countries. It also evaluates the effectiveness of financial education programmes to the extent possible and suggests actions policymakers can take to improve financial education and awareness.

This article is based on the executive summary of the book, which briefly discusses the factors increasing the importance of financial education, the benefits of financial education to consumers and the economy, the different ways in which financial education is provided, and the major findings of the report. The Appendix includes the OECD Council's Recommendation on Principles and Good Practices for Financial Education and Awareness.

Improving Financial Literacy: Analysis of Issues and Policies

I. Introduction

In 2003, the OECD established the Financial Education Project in response to the increasing interest of its member countries in improving the financial literacy of their consumers.¹ Phase one of this project has culminated in the publication of the first major study of financial education at the international level.² This book, *Improving Financial Literacy: Analysis of Issues and Policies* (OECD, 2005, forthcoming), contributes to the development of consumer financial literacy by providing information to policymakers on effective financial education programmes and by facilitating the sharing of experience in the field of financial education and awareness.

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Below is a summary of the book, which briefly discusses the factors increasing the importance of financial education, the benefits of financial education to consumers and the economy, the different ways in which financial education is provided, and the major findings of the report. The Appendix includes the OECD Council's Recommendation on Principles and Good Practices for Financial Education and Awareness.³

ii. Summary

The importance of financial education has increased in recent years as a result of financial market developments and demographic, economic and policy changes. Financial markets are becoming more sophisticated and new products

are continuously offered. Consumers now have greater access to a variety of credit and savings instruments provided by a range of entities from on-line banks and brokerage firms to community-based groups. As a result of changes in pension arrangements, an increasing number of workers will be assuming more responsibility for saving for their retirement. With the increase in life expectancy, individuals will need to ensure that they have adequate savings for the longer period they can expect to spend in retirement. These developments have important consequences for people saving or investing for retirement, for users of credit, and for the “unbanked”, the three groups of consumers that are the focus of this study.

Factors increasing the importance of financial education

- *The complexity of financial products.* Consumers are now faced with a variety of different types of financial instruments offering a range of options with respect to fees, interest rates, maturities, etc. In addition, the quality of some of these financial products, such as life insurance, is difficult to assess because they are purchased infrequently and there is often a significant lapse of time between purchase and use.
- *Increase in the number of financial products.* Deregulation of financial markets and the reduction in costs brought about by developments in information technology and telecommunications have resulted in a proliferation in the number of new products tailored to meet very specific market needs. The Internet has also increased both the amount of information about investment and credit products and the availability of these products.
- *The baby boom and increases in life expectancy.* Many OECD countries experienced a baby boom after the Second World War. The first of these baby boomers will begin retiring over the next five to ten years. As many baby boomers delayed childbearing or chose to have fewer children or none at all, the cohorts following the baby boom are much smaller. Thus, the retirement of the baby boom generation means that there will be fewer workers supporting a greater number of retirees. The situation is further compounded by the increase in life expectancy, which means that this large cohort might be spending more time in retirement than previous generations and might, therefore, need to be supported for a longer time. The ageing of the populations in OECD countries will have severe consequences for pay-as-you-go public retirement programmes.
- *Changes in pension arrangements.* A major trend in pension systems in the OECD countries is the shift from defined benefit to defined contribution pension schemes. In the former, the pension provider guarantees a set

retirement income, while in the latter it is the contribution levels that are set, with the retirement income depending upon the contribution rates and the investment decisions made during the individual's work life. As a result, more of the risk in pension provisioning is shifted from the provider to the worker. In the future, an increasing number of retirees will depend upon income from defined contribution pension plans.

- *Low levels of financial literacy.* A review of financial literacy surveys in twelve OECD countries concluded that financial understanding among consumers is low. Financial literacy levels are especially low for certain groups, such as the less educated, minorities, and those at the lower end of the income distribution.

Benefits of financial education to consumers and the economy

Financial education can benefit consumers of all ages and income levels. For young adults just beginning their working lives, it can provide basic tools for budgeting and saving so that expenses and debt can be kept under control. Financial education can help families acquire the discipline to save for a home of their own and/or for their children's education. It can help older workers ensure that they have enough savings for a comfortable retirement by providing them with the information and skills to make wise investment choices with both their pension plans and any individual savings plans. Financial education can help those at low income levels make the most of what they are able to save and help them avoid the high costs charged for financial transactions by non-financial institutions such as check cashing services. For those consumers with money to invest, financial education can provide increased understanding of basic financial information, such as the trade-off between risk and return and the value of compound interest, as well as more specific information about the advantages and disadvantages of particular types of investments.

Financially educated consumers can also benefit the economy. By demanding products more responsive to their needs, they encourage providers to develop new products and services, thus increasing competition in financial markets, innovation and improvement in quality. Financially educated consumers are also more likely to save and to save more than their less literate counterparts. The increase in savings associated with greater financial literacy should have positive effects on both investment levels and economic growth. In emerging economies, providing both information and training to consumers on the operation of markets and on the roles of market participants can help these countries make the most of their developing markets. In addition, financially educated consumers are in a better position to protect themselves on their own and to report possible misconduct by financial intermediaries to the authorities. Thus, they would facilitate supervisory activity and

might in principle allow for lower levels of regulatory intervention. As a result, there would be reduced regulatory burden on firms.

Provision of financial education

The most frequently used way of providing financial education is through publications. These publications take a variety of forms including brochures, magazines, booklets, guidance papers, newsletters, annual reports, direct mail documents, letters and disclosure documents. Another often used method is the Internet, in the form of Web sites, web portals, and other online services. Other methods used are advisory services, including telephone help lines; public educational campaigns and events, including presentations, lectures, conferences, symposia; and training courses and seminars and other types of channel, such as CD ROMs and videos, etc. The providers of financial education can be the public (or semi-public) sector: government agencies, ministries (of finance and social affairs, for example), central banks, and regulatory and supervisory authorities. Private sector providers of financial education include consumers' and employees' associations as well financial institutions. While many programmes are intended for consumers in general, some are targeted to specific groups, such as women, minorities, or those with low incomes.

Summary of report findings

- Countries are increasingly aware of the importance of financial education, providing a variety of financial education programmes and initiatives, ranging from Web sites, to distribution of brochures and pamphlets on selected financial issues, to offering of training courses or conducting media campaigns.
- Few countries have undertaken nationally representative financial literacy surveys to determine the financial issues that are of most concern and create a need for increased competence among consumers. The surveys that have been undertaken indicate that many consumers do not have an adequate financial background or understanding and that they often overestimate their knowledge of financial issues.
- There have been few evaluations of financial education programmes to determine what has worked well and what has not. This is, in part, due to the fact that programme evaluation is expensive and government budgets are limited. Equally important, however, is the difficulty of devising feasible measures to assess whether the main goals of financial education programmes – increasing consumer awareness and changing individual financial behaviour – have been fulfilled.

- Where evaluated, financial education programmes have been found to be effective. For example, research in the United States shows that workers increase their participation in and contributions to 401(k) plans when employers offer financial education programmes, whether in the form of brochures or seminars.
- Financial education programmes might not always be the only effective approach to improving consumer well-being. In certain circumstances other approaches might be needed either as a complement to or a substitute for financial education. Research in behavioural finance has shown, for example, that psychological traits, such as inertia and lack of willpower, reduce the effectiveness of financial education programmes. As a result, some pension experts have argued for automatic enrolment for defined contribution plans along with default contribution rates and default asset allocations.

Notes

1. Additional information on the Financial Education Project can be found in *Financial Market Trends*, No. 84, October 2004.
2. The research for this study was carried out under the supervision of the Committee on Financial Markets. This part of the project was supported by a grant from Prudential plc, an international financial services group based in the United Kingdom that provides retail financial services and fund management to clients in the United Kingdom, the United States, Asia, and continental Europe. Phase Two of the Financial Education Project will include an analysis of financial education programmes available in schools and universities.
3. This Recommendation was approved in June 2005 and is available on the OECD Web site at www.oecd.org/daf/financialeducation.

Appendix

Recommendation on Principles and Good Practices for Financial Education and Awareness

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Co-operation and Development of 14th December 1960;

Considering that, as financial education has always been important for consumers in helping them budget and manage their income, save and invest efficiently, and avoid becoming victims of fraud;

Considering that as financial markets become increasingly sophisticated and households assume more of the responsibility and risk for financial decisions, especially in the field of retirement savings, financially educated individuals are necessary to ensure sufficient levels of investor and consumer protection as well as the smooth functioning, not only of financial markets, but also of the economy.

Considering that surveys of financial literacy conducted in recent years in OECD countries show that consumers have low levels of financial literacy and lack awareness of the need to be financially educated;

Considering that governments and relevant public and private institutions (at national and sub-national level and including regulatory and supervisory bodies) in OECD and non-OECD countries may benefit from international guidance on principles and good practices for financial education and awareness;

Considering that their implementation will have to take into consideration various economic, social, demographic and cultural factors and, thus, will vary from country to country and that there are also numerous methods to develop successfully financial education for a particular audience;

Considering also that the implementation of the good practices related to financial institutions needs to take into consideration the diversity of financial institutions, that these guidelines do not prevent relevant commercial activities and that national associations of financial institutions are expected to be the main players for this subset of good practices;

On the proposal of the Committee on Financial Markets:

RECOMMENDS that Member countries promote financial education and awareness and in this respect that governments and relevant public and private institutions take due account of and implement the principles and good practices for financial education and awareness which are set out in the Annex to this Recommendation and form an integral part thereof.

INVITES Member countries to disseminate these principles and good practices among public and private (profit and not-for-profit) sector institutions that are involved in financial education and awareness and encourages non-member economies to consider them as appropriate.

INVITES Member countries, through their work in the Committee on Financial Markets, the Insurance Committee and its Working Party on Private Pensions, to identify further good practices respectively in the financial, insurance and pension education fields.

INSTRUCTS the Committee on Financial Markets to exchange information on progress and experiences with respect to the implementation of this Recommendation, review that information and report to the Council within three years of its adoption, or sooner, and, as appropriate, thereafter.

Annex

**Principles and Good Practices
for Financial Education and Awareness**

I. Principles

1. *Financial education can be defined as “the process by which financial consumers/investors improve their understanding of financial products, concepts and risks and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being”. Financial education thus goes beyond the provision of financial information and advice, which should be regulated, as is already often the case, in particular for the protection of financial clients (i.e. consumers in contractual relationships).*
2. *This financial capacity building, based on proper financial information and instruction, should be promoted. Financial education should be provided in a fair and unbiased manner. Programmes should be co-ordinated and developed with efficiency.*
3. *Financial education programmes should focus on high priority issues, which, depending on national circumstances, may include important aspects of financial life planning such as basic savings, private debt management or insurance as well as pre-requisites for financial awareness such as elementary financial mathematics and economics. The awareness of future retirees about the need to assess the financial adequacy of their current public or private pensions schemes and to take appropriate action when needed should be encouraged.*
4. *Financial education should be taken into account in the regulatory and administrative framework and considered as a tool to promote economic growth, confidence and stability, together with regulation of financial institutions and consumer protection (including the regulation of financial information and advice). The promotion of financial education should not be substituted for financial regulation, which is essential to protect consumers (for instance against fraud) and which financial education is expected to complement.*
5. *Appropriate measures should be taken when financial capacity is essential but deficiencies are observed. Other policy tools to consider are consumer protection and financial institution regulation. Without limiting the freedom to contract, default mechanisms,*

which take into consideration inadequate financial education or passive/inert behaviour, should be considered.

6. *The role of financial institutions in financial education should be promoted and become part of their good governance with respect to their financial clients. Financial institutions' accountability and responsibility should be encouraged not only in providing information and advice on financial issues, but also in promoting financial awareness clients, especially for long-term commitments and commitments which represent a substantial proportion of current and future income.*
7. *Financial education programmes should be designed to meet the needs and the financial literacy level of their target audience, as well as reflect how their target audience prefers to receive financial information. Financial education should be regarded as a life-time, on-going and continuous process, in particular in order to take account of the increased complexity of markets, varying needs at different life stages, and increasingly complex information.*

II. Good practices

A. Public action for financial education

8. *National campaigns should be encouraged to raise awareness of the population about the need to improve their understanding of financial risks and ways to protect against financial risks through adequate savings, insurance and financial education.*
9. *Financial education should start at school. People should be educated about financial matters as early as possible in their lives.*
10. *Consideration should be given to making financial education a part of state welfare assistance programmes.*
11. *Appropriate specialised structures (possibly embedded within existing authorities) in charge of promoting and coordinating financial education should be encouraged at the national level and regional and local public and private initiatives as close to the population as possible should also be promoted.*
12. *Specific web sites should be promoted to provide relevant, user-friendly financial information to the public. Free information services should be developed. Warning systems by consumer, professional or other organisation on high-risk issues that may be detrimental to the interests of the financial consumers (including cases of fraud) should be promoted.*
13. *International co-operation on financial education should be promoted, including the use of the OECD as an international forum to exchange information on recent national experiences in financial education.*

B. Role of financial institutions in financial education

14. Requirements to specify the types of information (including where to find information and the provision of general comparative and objective information on the risks and returns of different kinds of products) that financial institutions need to provide to clients on financial products and services should be encouraged.
15. Financial institutions should be encouraged to clearly distinguish between financial education and financial information and "commercial" financial advice. Any financial advice for business purposes should be transparent and disclose clearly any commercial nature where it is also being promoted as a financial education initiative. For those financial services that entail long-term commitment or have potentially significant financial consequences, financial institutions should be encouraged to check that the information provided to their clients is read and understood.
16. Financial institutions should be encouraged to provide information at several different levels in order to best meet the needs of consumers. Small print, abstruse documentation should be discouraged.
17. Financial education provided by financial institutions should be regularly assessed to ensure it meets consumer needs. This may be achieved through partnerships with independent, not for profit financial advisory bodies that may have better connections with consumers, particularly those facing disadvantage in their participation in financial markets.
18. Financial institutions should be encouraged to train their staff on financial education and develop codes of conduct for the provision of general advice about investment and borrowing, not linked to the supply of a specific product.

C. Financial education for retirement savings

19. For individuals in private personal pension plans, the provision by financial institutions of the appropriate financial information and education required for the management of their future retirement savings and income should be promoted.
20. Concerning occupational schemes (for which the related information and education should be provided in a consistent way across the schemes), financial education and awareness of employees and related policy tools should be further promoted, both for defined contribution and defined benefit schemes.

D. Financial education programmes

21. Financial education programmes that help financial consumers find the facts and understand the pros and cons as well as the risks of different types of financial products

- and services should be promoted. Further research on behavioural economics should be promoted.*
22. *The development of methodologies to assess existing financial education programmes should be promoted. Official recognition of financial education programmes which fulfil relevant criteria should be considered.*
 23. *Financial education programmes that develop guidelines on study content and accomplishment level for each financial education programme and for each population sub-group should be promoted.*
 24. *In order to achieve a wider coverage and exposure, the use of all available media for the dissemination of education messages should be promoted.*
 25. *In order to take into account the diverse backgrounds of investors/consumers, financial education that creates different programmes for specific sub-groups of investors/consumers (i.e. young people, the less educated, disadvantaged groups) should be promoted. Financial education offered through seminars and personalised financial counselling programmes should be related to individual circumstances.*
 26. *For those programmes which favour use of classrooms, proper education and competence of the educators should be promoted. In this respect, the development of programmes to “train the trainers” and the provision of specific information material and tools for these trainers should be encouraged.*

Résumé : Pour une meilleure éducation financière : Enjeux et initiatives

En 2003, l'OCDE a lancé un Projet sur l'éducation financière face à l'intérêt croissant de ses pays membres pour l'amélioration des compétences financières de leurs consommateurs. La Phase I de ce projet a atteint son apogée avec la publication de la première grande étude internationale consacrée à l'éducation financière. Cet ouvrage, *Pour une meilleure éducation financière : enjeux et initiatives* (OCDE, 2005, à paraître), contribue au développement des compétences financières des consommateurs en donnant des informations aux autorités sur les programmes efficaces d'éducation financière et en facilitant l'échange d'expériences dans le domaine de l'éducation et de la sensibilisation à la finance.

L'ouvrage recense et analyse les études sur l'éducation financière dans les pays membres, souligne les évolutions économiques, démographiques et politiques qui confèrent une importance croissante à l'éducation financière et décrit les différents types de programmes d'éducation financière actuellement proposés dans les pays de l'OCDE. Il évalue par ailleurs dans toute la mesure du possible l'efficacité de ces programmes et propose aux autorités des mesures susceptibles d'améliorer l'éducation et la sensibilisation à la finance.

Cet article fait la synthèse de l'ouvrage qui évoque brièvement les facteurs accroissant l'importance de l'éducation financière, les avantages de l'éducation financière pour les consommateurs et l'économie, les différentes formes sous lesquels l'éducation financière se présente et les principales conclusions du rapport. L'annexe reproduit les Recommandations du Conseil de l'OCDE sur les principes et bonnes pratiques relatifs à la sensibilisation et l'éducation financières.

Abstract: The Aggregate and Structural Impact of Ageing on Financial Markets: Some Quantitative Assessments

Ageing will translate into long run trends in supply as well as demand of capital in the next decades. This paper provides some quantitative assessments of the effects on financial markets of ageing in four large OECD countries (United States, Japan, Germany, and France). Using a simplified general equilibrium model with overlapping generations, it suggests that ageing could bolster capital-labour ratios and lower interest rates in the future (by 25 bp to 100 bp in the long run, depending on the characteristics of pension systems reforms). In this context, the fear for a future “asset meltdown” due to ageing is probably overstated. The model also suggests that the individual accumulation of capital is likely to increase in the future and require structural changes in financial markets. Households will increasingly need to insure against the uncertainty related to future asset prices, rates of return on capital or individual longevity. This paper assesses the welfare gains an individual can benefit by purchasing an annuity at retirement. It suggests that buying annuities, even if actuarially unfair, may significantly increase households’ welfare. These results call for policies supporting the development of annuities markets failures and reverse mortgages.

The Aggregate and Structural Impact of Ageing on Financial Markets: Some Quantitative Assessments*

Ageing will most probably translate into long run trends in supply as well as demand of capital. Changes in the supply of capital will stem from the impact of ageing on the households' aggregate saving rate, in line with the life-cycle hypothesis. Changes in the demand of capital will mainly flow from movements in the capital-labour ratios, mirroring the deceleration of the labour force and changes in the prices of capital and labour. Overall, ageing is likely to alter interest rates and asset prices in the long run.

This paper provides some quantitative assessments of these effects for four large OECD countries (United States, Japan, Germany, and France). In order to do so, it relies on a simplified general equilibrium model with overlapping generations calibrated to fit the characteristics of these countries (see Oliveira Martins, Gonand, Antolin, de la Maisonnette and Yoo, 2005). This model suggests that ageing could bolster capital-labour ratios and lower interest rates in the future. Nevertheless, the magnitude of these effects would not be very sizeable in most cases and remain dependant on the characteristics of pension systems reforms. In a rather extreme scenario where the viability of the public PAYG system is restored exclusively via reduced replacement rates and the expansion of private pension schemes, the decline in interest rates could be at most around 100 basis points in the United States and 150 basis points in Japan in 2050. For admittedly more realistic pension reform scenarios, the decline could be smaller, between 25 bp and 75 bp in the long run.

* This note was prepared by Frédéric Gonand, economist in the OECD Economics Department. It draws on background documents prepared for and discussed at meetings of the OECD Economic Policy Committee (see Oliveira Martins J., F. Gonand, P. Antolin, C. de la Maisonnette and K.-Y. Yoo, 2005). E-mail: frederic.gonand@oecd.org. The author would like to thank Joaquim Oliveira Martins, Pablo Antolin, Christine de la Maisonnette, Giuseppe Nicoletti, Jorgen Elmeskov and Mike Feiner for helpful comments.

In this context, this paper examines the accuracy of the “asset meltdown” argument and suggests that such a fear is probably overstated. Schieber and Shoven (1994) argued that the impact of ageing on interest rates and asset prices would destabilise capital markets around 2020-2030, with pension funds becoming net sellers of financial assets and massive detrimental side-effects on the cost of capital and growth prospects.

The reforms of pension regimes in an ageing context are also likely to lead to an increase in individual accumulation of capital. This would be the case if policies enhancing private saving in pension funds or raising the effective retirement age are implemented. In the latter case, lifetime accumulation of wealth would increase because lifetime labour income would be higher and individuals wish to have a greater retirement income.

This likely greater reliance on private saving for resources in retirement may require structural changes in financial markets. Households may increasingly need to insure against the uncertainty related to future asset prices, rates of return on capital or individual longevity. Individuals could insure themselves against these risks through precautionary saving. Yet this would lower welfare since households would consume less during their lifetime. Shifting the uncertainty away from households through insurance markets could improve overall efficiency. In theory, this could be achieved if individuals were allowed to exchange all or part of their accumulated wealth for annuities (Yaari, 1965).

This paper assesses the welfare gains an individual can benefit from purchasing an annuity at retirement. It draws on the existing literature (Kotlikoff and Spivak, 1981) to calibrate a simple analytical model on 30 OECD countries’ data in order to estimate the welfare gains of purchasing an annuity at retirement. This model suggests that purchasing annuities, even when actuarially unfair, may still increase significantly households’ welfare. These results may call for policies supporting the development of annuities and addressing the annuities markets failures. Apart from annuities, other financial instruments may prove especially useful in an ageing context, notably reverse mortgages which, contrary to standard annuities, allow for leaving a bequest.

Measuring the aggregate impact of ageing on capital markets

Changes in the age structure of the population will translate into movements in aggregate saving rates and the supply of capital. In this context, actions implemented to make pay-as-you-go (PAYG) pension regimes sustainable during the demographic transition will interact with ageing trends to shape capital accumulation in OECD countries. This section begins with a brief summary of the main features of a general equilibrium model used to assess the impact of ageing and

pension reforms on capital markets up to 2050. It then expands on its main results as concerns the impact of ageing on capital markets and individual capital accumulation.

A simple general equilibrium model to assess the impact of ageing on long-run interest rates

A standard general equilibrium model with overlapping generations (see Box 1) was replicated for different countries: the United States (slow ageing), Japan and Germany (fast ageing) and France (intermediate ageing).¹ The model focuses on long run phenomena affecting factor markets: capital accumulation – since aggregate saving is correlated with age – and labour force. The economies return to a stable population level and structure by 2080 when a steady state equilibrium is reached. In this situation, GDP per capita growth is exclusively determined by the (exogenous) growth in total factor productivity (TFP = 1.5 per cent) and capital deepening grows in line with TFP at 0.45 per cent per annum.² By contrast, during the demographic transition, the dynamic equilibrium is driven by ageing trends and pension reforms.

The model is used to derive the implications of three alternative reforms of PAYG pension regimes for capital markets. In the “*rising contribution rate*” scenario, pension regimes are balanced over time by increasing contribution rates while leaving replacement rates and retirement ages unchanged. In the “*gradually increasing age of retirement*” scenario, reforms increase the legal age at which an individual can receive a full pension. The rise in the official age of retirement is set at 1¼ years per decade, in line with the average increase in longevity underlying national demographic projections. The residual imbalances of the PAYG regime are covered by changes in contribution rates.³ Eventually, in the “*pension saving*” scenario, contribution rates are frozen after 2005 and the system is balanced by gradually decreasing replacement rates for *new* retirees. This motivates agents to increase private savings to sustain consumption levels upon retirement.

In the “*gradually increasing age of retirement*” and “*pension saving*” reform scenarios, policy changes are implemented from 2005 onwards. When the reform is announced, households revise their optimal saving paths in order to smooth future consumption levels. This implies that before 2005 consumption for each cohort remains equal to its level in the “*rising contribution rate*” scenario.

Results point to a significant and sometimes substantial impact of future demographic changes on capital accumulation (see Figure 1 to Figure 4):

- In the “*rising contribution rate*” scenario, balancing PAYG systems in the context of ageing requires sizeable increases in contribution rates. These increases would be especially sizeable in France and Japan, and more

Box 1. **Main features of the overlapping generations model**

The general equilibrium model with overlapping generations embodies 79 cohorts. Each cohort has a maximum life span of 20 to 99 years and a specific mortality profile. The national demographic projections, based on five-year periods by age groups, were transformed in order to obtain coherent yearly profiles as well as survival probabilities for each cohort. The specification of the model draws mainly on Miles (1999) and Börsch-Supan *et al.* (2002).

Each country is viewed as a closed economy and the labour market is exogenous. The latter assumption implies that there is no intertemporal trade-off between consumption and leisure. An extended version of the model, endogenising this intertemporal choice, suggests that results do not change qualitatively for any reasonable choice of parameters. Taking into account international capital flows would probably smooth out the impact of ageing. Nevertheless, to fit with observed patterns of capital flows, a much heavier calibration procedure would be required and the specification would be less robust.

The production function has constant returns to scale, involving capital, labour and a labour-augmenting total factor productivity (TFP). Individuals optimise their consumption path over their lifetimes and do not have any bequest motives. They are either employed, unemployed, retired or none of these (in which case they do neither contribute nor get a pension). The model incorporates a public PAYG pension regime (Social Security) where pension are proportional to past wages. The model is solved by equalising numerically the demand of capital (for production) and the supply of capital (from household savings). All variables are expressed in real terms.

The model is parameterised using a capital share in output of 0.3, an elasticity of substitution between capital and labour of 1.25 in line with the long-term characteristics of the model, and TFP gains were assumed to be at 1.5 per cent per year. The households' discount rate is fixed at 3 per cent (cf. Gourinchard and Parker, 2002). The risk aversion parameter is set at 1.33, in line with recent studies. Replacement rates are country-specific and calculated as the ratio between average pension payments and average earnings. Unemployment rates are frozen at their level of 2000, as are participation rates for each age group, except in the "gradually increasing age of retirement" scenario.

The model is calibrated on an interest rate of 4.5 per cent in the base year (corresponding to the sum of TFP gains and the discount rate), as suggested by the life-cycle theory. This assumption yields realistic contribution rates and capital/income ratios but has no impact on the profile of macroeconomic variables over time. Contrary to some studies, the model is not calibrated on the households' risk aversion parameter in order to reproduce observed variations in the stock of capital around the base year. This calibration procedure can generate rather high levels of risk aversion, resulting in a very inelastic reaction of households to interest rate movements. Sensitivity analysis suggests that the model is reasonably robust to the calibration procedure and parameter choices.

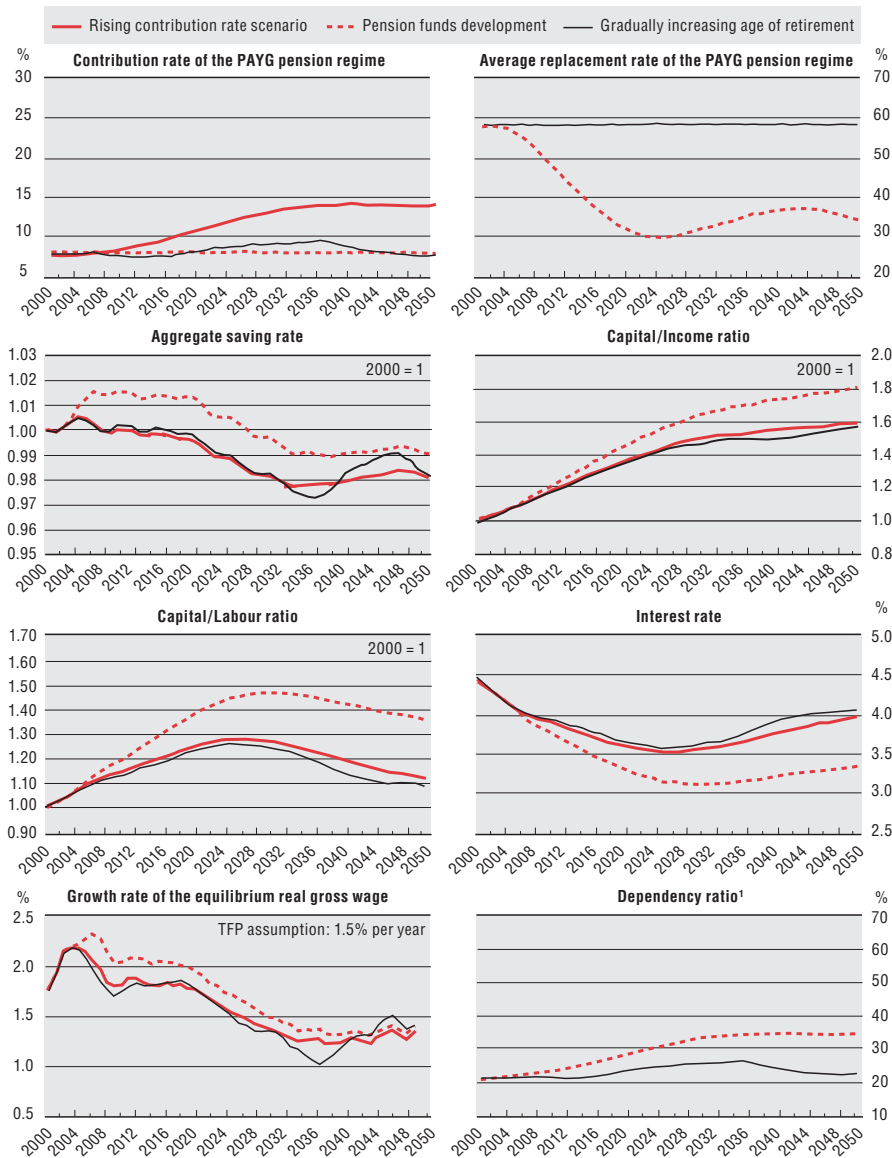
moderate in the United States, reflecting differences in the speed of ageing and the level of replacement rates. Movements in the capital-labour ratio reflect the relative speed of the decline in saving and labour supply. They are bell-shaped in France and the United States, and rise above their initial levels in Germany and Japan, in line with increasing scarcity of labour in these two countries. Movements in the real interest rate mirror the evolutions of capital-labour ratios. Their amplitude would remain subdued: from – 70 bp to +30 bp in 2050 depending on the country considered.

- Capital accumulation outcomes of the “pension saving scenario” depart significantly from the previous scenario. With replacement rates declining to 25-35 per cent by 2050, prime-age households save much more in order to avoid a sharp reduction of revenues and consumption after retirement. Capital-labour ratios increase significantly in all countries. The decline in interest rates is more pronounced over the simulation period (up to 100 basis points in the United States and 150 basis points in Japan).
- In the “gradually increasing age of retirement scenario”, increasing retirement age in line with projected longevity gains significantly slows down the increase in dependency ratios. The increase in contribution rates required to balance PAYG systems is much smaller than in the previous scenario (except in Japan). The profiles of capital-labour ratios remain similar to those of the “rising contribution rate” scenario. The tendency of individuals to reduce saving in line with a shorter retirement span is compensated by the longer working life period during which they save. Capital-labour ratio profiles tend, however, to be flatter especially in Germany and France, partly reflecting a wider scope for increasing labour force participation of old-age workers in these countries.

Overall, these simulations suggest that increasing the effective age of retirement in order to balance PAYG regimes may have stabilising effects on capital markets and interest rates, with limited distorsive effects on labour market. By contrast, restoring the viability of the PAYG pension systems via reduced replacement rates and the expansion of private pension schemes would trigger a sharper downward trend in long-run interest rates.

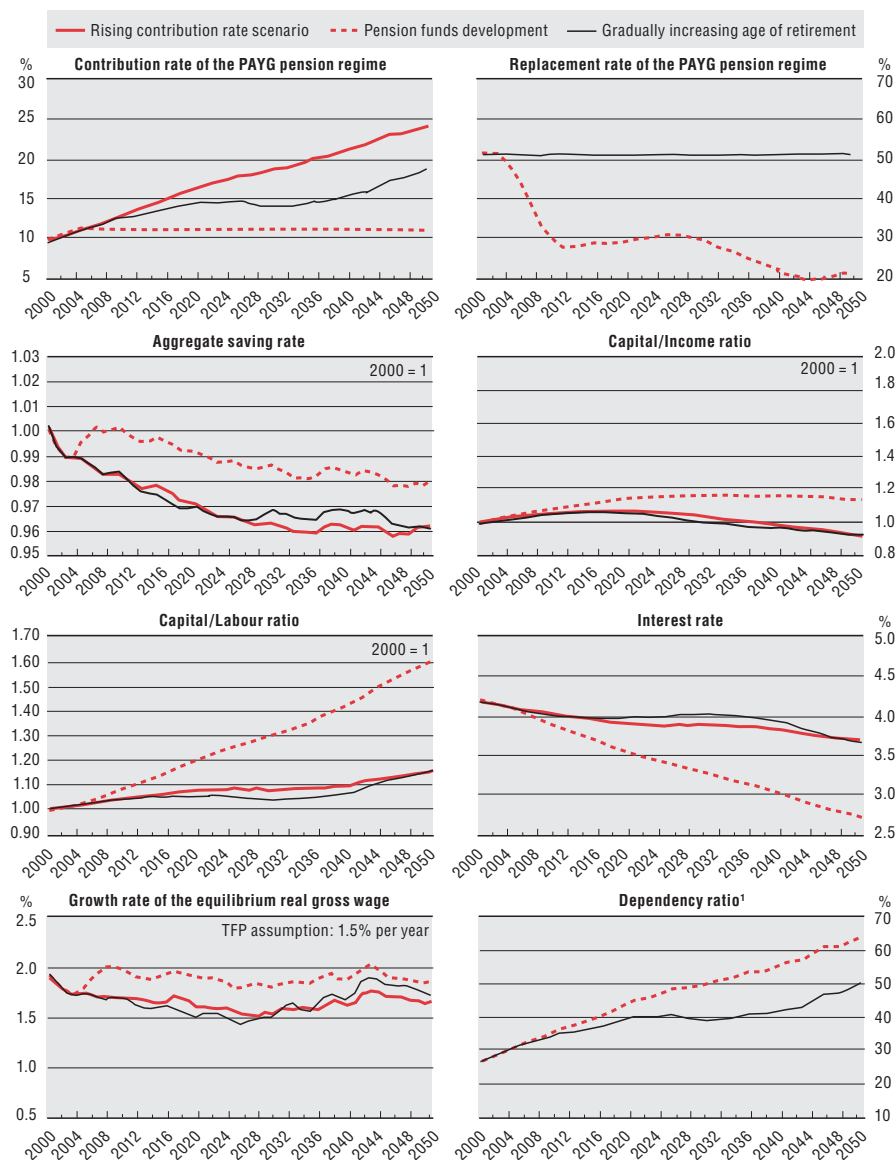
These results give little support to the “asset meltdown hypothesis” according to which the massive pension withdrawals during the second phase of the ageing process could induce a large decline in asset prices (see Box 2). Other quantitative studies using general equilibrium models also tend to reject this hypothesis. This is because the asset meltdown hypothesis reflects a partial equilibrium view where changes in economic agents’ behaviour spurred by interest rates movements are not taken into account. The hypothesis may also be based on an exclusive focus on the impacts of ageing on savings, ignoring the impacts via

Figure 1. **Simulations of the GE model for the United States**
Participation rates frozen at their 2000 levels,
unless in the gradually increasing age of retirement scenario



1. Retired population/labour force.
Source: OECD calculations.

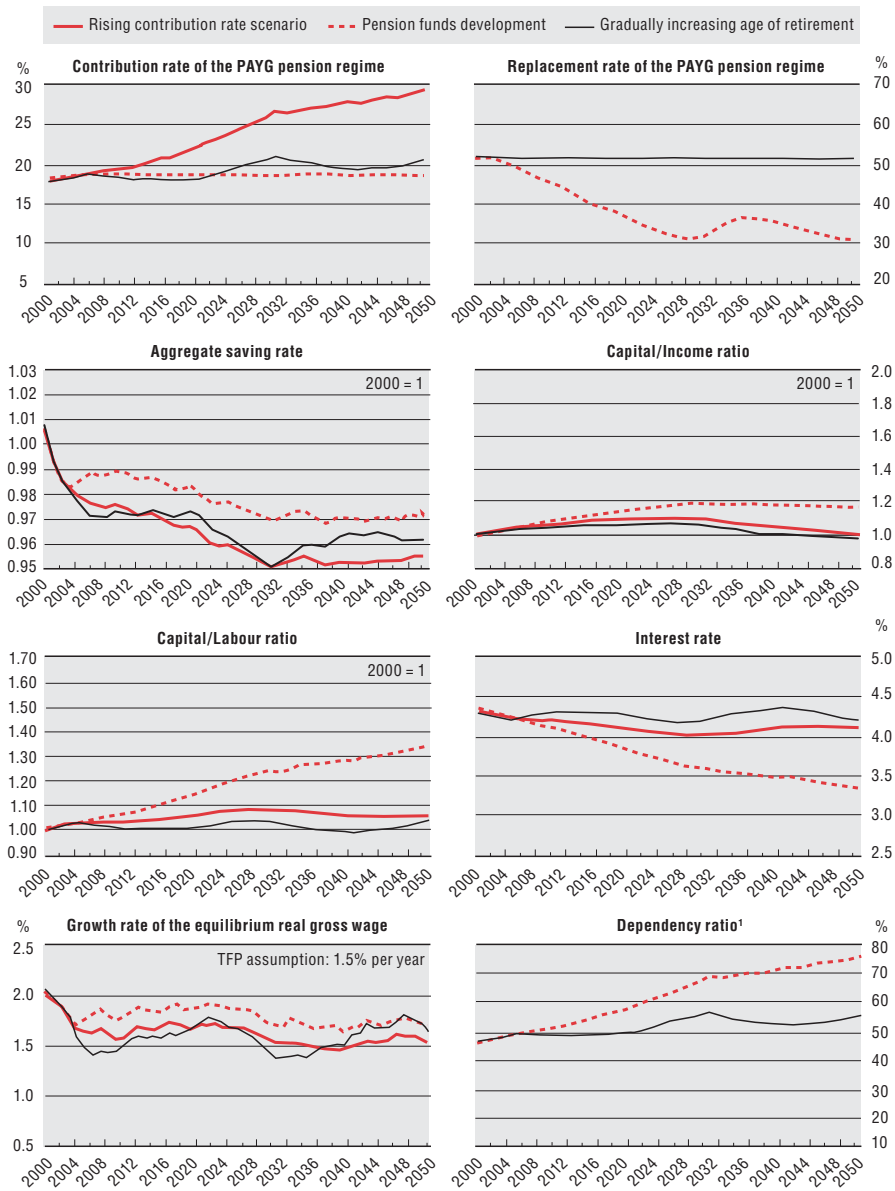
Figure 2. **Simulations of the GE model for Japan**
Participation rates frozen at their 2000 levels,
unless in the gradually increasing age of retirement scenario



1. Retired population/labour force.

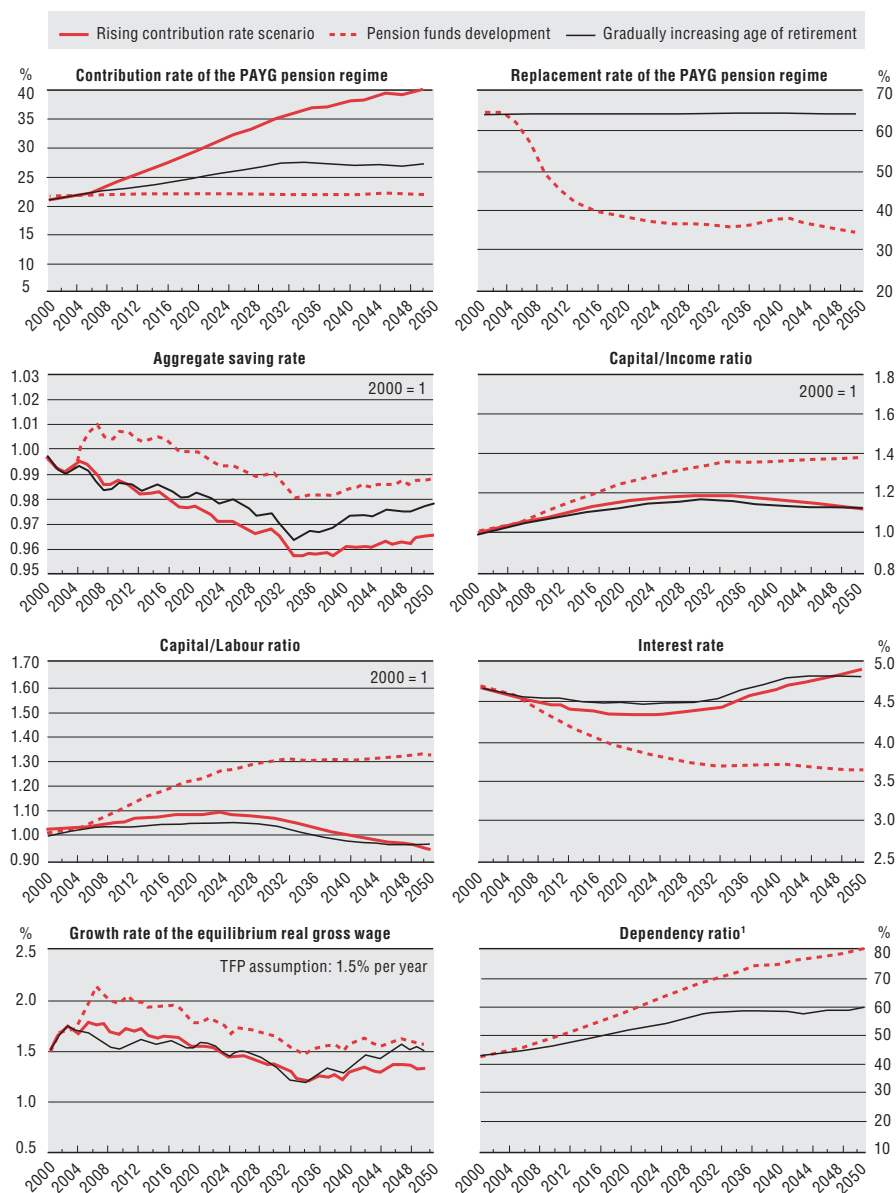
Source: OECD calculations.

Figure 3. Simulations of the GE model for Germany



1. Retired population/labour force.
Source: OECD calculations.

Figure 4. Simulations of the GE model for France



1. Retired population/labour force.

Source: OECD calculations.

labour supply on investment. In a general equilibrium setting, accounting for these mechanisms largely offsets the asset meltdown effect.

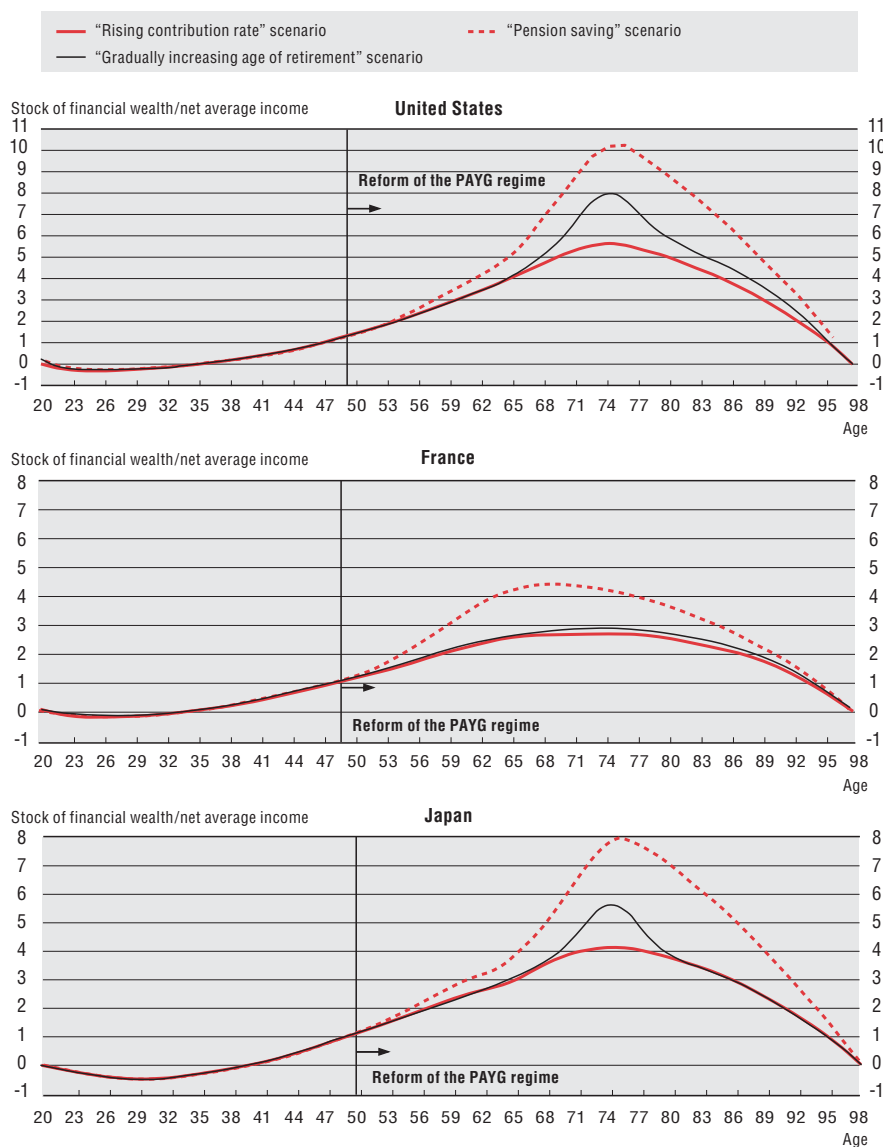
A related issue is whether downward pressure on asset prices during the second phase of the ageing process (after 2025-30) could induce households to shift their portfolios from stocks to bonds. Given the limited impact of ageing trends on interest rates, as suggested by the simulations described above, this reallocation effect might not be large. Moreover, there is little consensus in the literature about the impact of expected fluctuations in asset prices on households' portfolio strategies.

Policies that enhance saving incentives such as in the "pension saving" scenario are likely to lead to an increase in *individual* accumulation of capital. Similarly, reforms raising the age of retirement bolster lifetime accumulation of wealth because lifetime labour income is higher and individuals wish to have a greater retirement income (Figure 5). This greater reliance on private saving for financing the retirement period in both cases is likely to require structural changes in financial markets.

Box 2. **The asset meltdown hypothesis**

An increase of pension savings, especially in countries with dominant PAYG schemes, would entail a positive net demand for financial assets at the beginning of the ageing process. This would hold as long as the sum of contributions and the flows of interest received from assets outpace the amount of pensions to be paid. The decline in the labour force and the rise in the retired population suggest that these conditions will not be met in the future. If so, pension funds might become structural net sellers of financial assets on a wide scale, creating downward pressures on asset prices and pushing up interest rates. This "asset-meltdown" phenomenon could trigger detrimental side-effects on the cost of capital for businesses (Schieber and Shoven, 1994) and affect growth prospects.

International diversification of capital investment could counteract these effects, as rapidly-ageing countries could use capital investments in relatively younger countries to push up their rate of return on capital (McMorrow and Roeger, 2003). The scope for these international saving flows in turn is not clear: the positive effect of international diversification on asset returns can be hindered by the exchange rate risk on capital investment, a remaining "home bias", or poor financial environment in developing countries (Blair and Lorentzen, 2003). In any case, the demographic transition in emerging and developing countries is taking place at a much faster pace than in the OECD, reducing in the long run the benefit from investing abroad. A stronger theoretical argument against the asset-meltdown hypothesis is raised by Schich (2004): the asset-meltdown hypothesis seems at odds with rational expectations on financial markets: were it to happen, markets would anticipate it, smoothing out future ageing-driven movements of asset prices.

Figure 5. Accumulated wealth of an individual under different scenarios¹


1. Wealth accumulated by an individual joining the labour market in 1975 at the age of 20. The calculations assume that the individual lives until age 99 when assets are run down. Levels of financial wealth may not be comparable to actual levels since households in the model only save for retirement.

Source: OECD calculations.

Some aspects of the structural impact of ageing on financial markets: annuities and reverse mortgages

The likely greater reliance on private saving for financing the retirement period reinforces the need for households to insure against uncertainties about asset prices, the rate of return on capital and individual longevity. The longevity risk corresponds to the risk of living longer than anticipated and outliving one's accumulated assets. These risks can be insured against by precautionary savings. Yet such a choice may not be optimal since precautionary savings lowers overall welfare and consumption. The theoretical setting developed by Yaari (1965) suggests that the optimum in this context consists in exchanging its accumulated assets for an annuity.

Annuities markets: a brief overview

An annuity is an insurance contract where the insurer pays out a periodic sum to an annuitant for the rest of his/her life in exchange for a given sum (called *premium*). It allows insuring against the longevity risk by pooling it across the group of annuitants. It shifts the longevity risk away from households to the insurer. An annuity can take many forms: immediate or deferred, fixed or variable (escalating or inflation-indexed), with or without options for conditional payments to heirs in the event of premature death of an annuitant. This section focuses on the standard annuity, *i.e.* a single-premium immediate fixed annuity. Box 3 provides some basics on annuities markets.

An analytical model parameterised for OECD countries

This sub-section assesses the individual welfare gains of purchasing an annuity at retirement. It suggests that, under reasonable assumptions, these gains could be substantial.

To assess empirically whether a retiring individual could benefit from purchasing an annuity with his/her accumulated capital, even in a context of market failure, we rely basically on the method developed by Kotlikoff and Spivak (1981) (Box 4). In this setting, the welfare gain (or loss) of buying an annuity at retirement is defined and computed as the amount of assets required at the time of retirement that is needed to leave a non-insured individual as well off as an individual that buys an annuity.

Figure 6 shows the value of this amount of capital as a share of initial assets in OECD countries for an actuarially fair annuity and different degrees of risk aversion. The welfare gains of buying an annuity are substantial: to reach the same

level of utility as with an annuity, an individual with no annuity would need between 25 per cent and 45 per cent more assets at age 65 in the model. These results are in line with Kotlikoff and Spivak (1981) and Mitchell *et al.* (1999).⁴

Box 3. Annuity markets

Let A stand for the fixed sum paid by the insurer on a yearly basis, p_t the *average* survival probability over the whole population (conditional on the age of the annuitant at the date of purchase of the annuity, noted a), r_t the risk-free long-run real interest rate, S the premium paid by the annuitant and D the age of the annuitant at death. The annuity is actuarially fair for the average individual if the discounted value of the stream of future payments associated with the purchase of this annuity is equal to the premium:

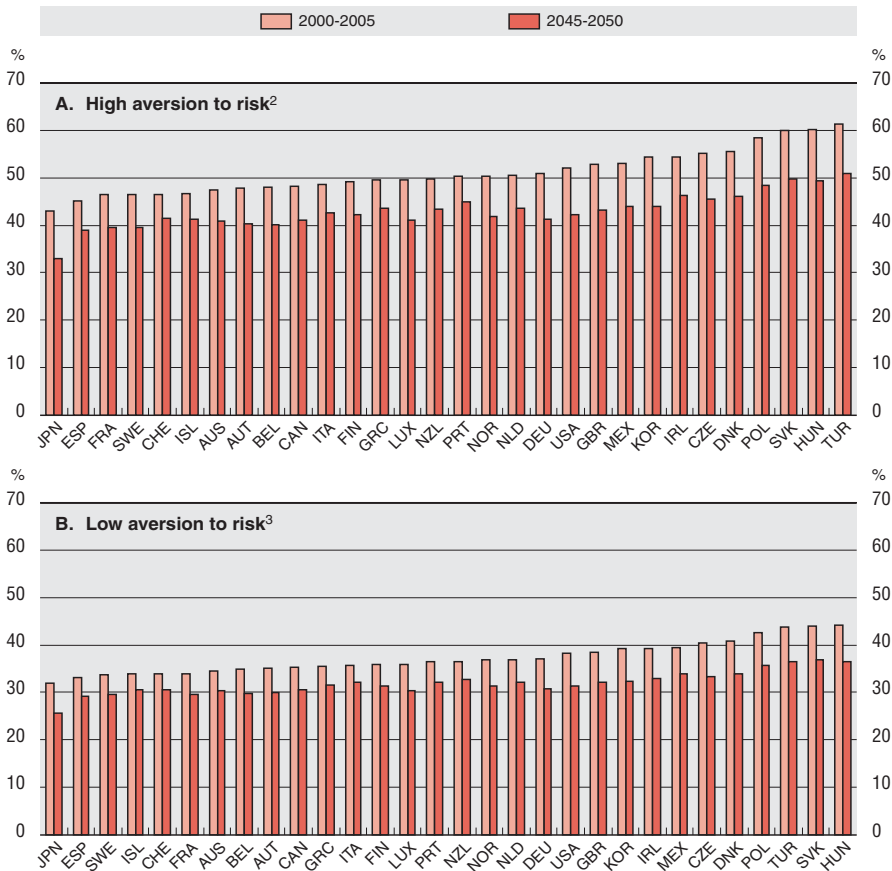
$$S = \sum_{t=a}^D \left(A \cdot p_t / \prod_1^t (1 + r_t)^t \right)$$

There are several reasons why an annuity could not be actuarially fair and entail a net cost compared with a standard risk-free investment: administrative and marketing costs levied by insurers, corporate taxation and, especially, asymmetries of information in the insurance market.

Asymmetries of information about survival probabilities of annuitants stem from the fact that annuitants have more information on their behaviour and survival prospects than their insurers, and that they do not have any interest in disclosing this information since the longer than average they live, the higher their return on an annuity. In this context, Rothschild and Stiglitz (1976) suggest that the optimal strategy for insurers implies selling annuities at a higher price S than if average population survival probabilities had been used – a price that is more or less fair for the average *annuitant*, but not for the average *individual* (antiselection).

According to some empirical studies, the average difference between the price of the annuity and the fair price could be around 13.5 per cent of the price paid for a 65-year old male in the United Kingdom (Finkelstein and Poterba, 2002). On US data, Mitchell *et al.* (1999) obtain a close figure of 18.6 per cent. Mitchell *et al.* (1999) argue that such a difference cannot fully account for the very small development of voluntary annuity markets in most countries. Indeed, annuities provide a valuable service by insuring households against longevity risk, which justifies a lower rate of return than on other financial instruments. A possible, but not entirely convincing explanation is related to bequest motives (Friedman and Warshawsky, 1988 and 1990).

Figure 6. Welfare gains from buying an actuarially “fair” annuity¹



1. Increase in the stock of capital at retirement age needed to remain indifferent between buying an annuity or not. Retirement age is 65 and λ is set at 1. The discount rate is set equal to the real interest rate at 3 per cent.
2. The relative-risk aversion coefficient is set at 2.0.
3. The relative-risk aversion coefficient is set at 0.9.
Source: OECD calculations.

Box 4. Assessing the welfare gains of buying an annuity at retirement

An individual wellbeing is measured in terms of consumption (c_t) Each individual retires at 65, for which t is set at 0, and maximizes the following standard

CRRA utility function: $U_t = \sum_{t=0}^D \left[(1+\rho)^{-t} (1-\gamma)^{-1} P_t c_t^{1-\gamma} \right]$, where D stands for

the maximum life expectancy (set at 110 years), ρ for the discount rate, γ for the relative-risk aversion coefficient, and P_t for the average survival probability after t years. There is no bequest motive.

Retirement income is generated by the amount of assets accumulated at the time of retirement (W_0). The budget constraint in this maximisation problem depends on whether the individual buys an annuity or not. In Kotlikoff and Spivak's setting, the individual is assumed not to receive any income from his/her capital. Additionally, he/she can not borrow on capital markets in case he/she outlives his/her assets (this is in line with no income during retirement).

If no annuity is purchased, the budget constraint is: $W_0 = \sum_{t=0}^D \left[(1+r)^{-t} c_t \right]$.

In other words, an individual facing this longevity risk behaves as if he/she would live with certainty until the maximum possible length of life D . If he/she dies before reaching D , accidental bequests are left, which is sub-optimal here.

If an annuity is purchased, the budget constraint becomes:

$$\lambda \cdot W_0 = \sum_{t=0}^D \left[(1+r)^{-t} P_t c_t \right].$$

On the right-hand side, this expression reflects the fact that an annuity scheme is equivalent to a situation where the survival probabilities are perfectly known. As the annuitant receives regular payments during retirement, he/she does not face a longevity risk any more, whatever his date of death. Optimal consumption behaviour then derives from using average survival probabilities P_t . There are no accidental bequests since the annuitant sold all of its accumulated capital for purchasing the annuity. On the left-hand side, parameter λ encapsulates marketing costs, corporate taxes, insurer profit and, mainly, adverse selection. It measures the difference between the discounted value of future periodic payments and the premium charged by the insurer. When $\lambda = 1$, the annuity is actuarially fair for the average individual. This is the case Kotlikoff and Spivak's (1981) model focuses on. When $\lambda < 1$, the annuity is unfair for the average individual. In practice, λ is less than one and annuities are likely to entail a net cost compared to a standard riskless investment.

First order conditions of optimisation yield to the following maximum discounted utilities associated with W_0 . When no annuity is bought, the FOC is:

$$N_0(W_0) = (1-\gamma)^{-1} W_0^{1-\gamma} \left[\sum_{t=0}^D (1+r)^{t(1-\gamma)/\gamma} (1+\rho)^{-t/\gamma} P_t^{\frac{1}{\gamma}} \right]^{\gamma}.$$

Box 4. Assessing the welfare gains of buying an annuity at retirement (cont.)

When no annuity is bought, it becomes:

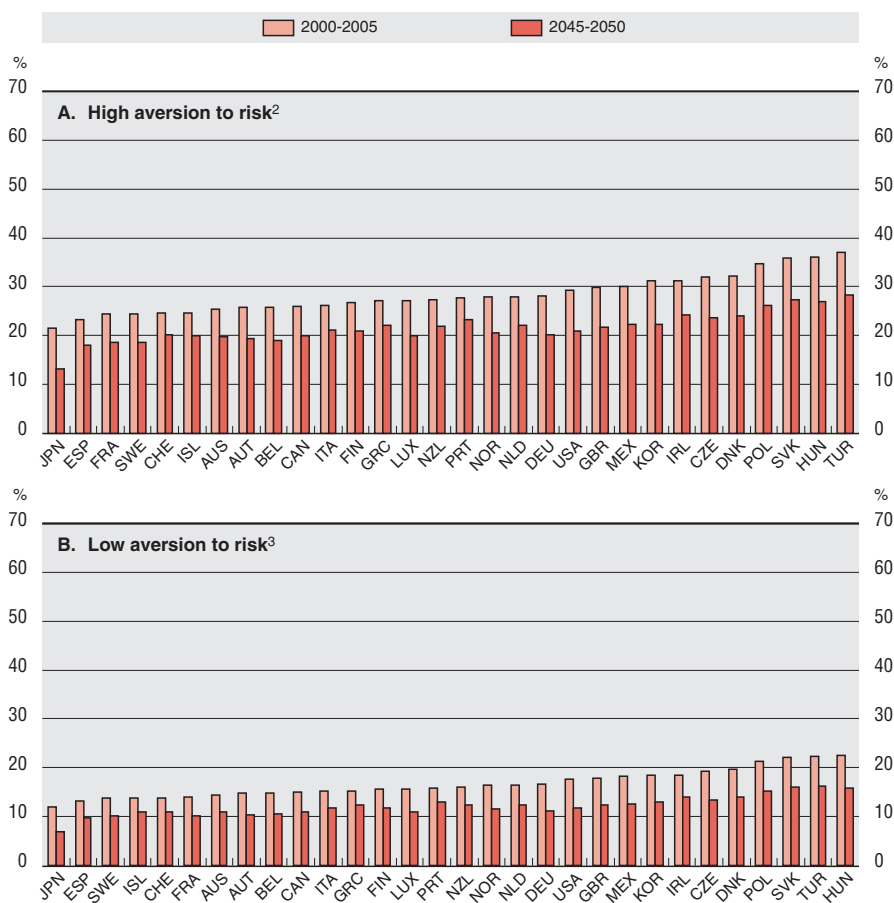
$$A_0(W_0) = (1-\gamma)^{-1} (\lambda W_0)^{1-\gamma} \left[\sum_{t=0}^D (1+r)^{t(1-\gamma)/\gamma} (1+\rho)^{-t/\gamma} P_t \right]^\gamma.$$

These equations allow for computing the variation of initial assets (noted M) required in the no-annuity case so as to leave a 65-year old individual indifferent between buying or not buying an annuity. This amounts to solving numerically the equation $A_0(W_0) = N_0(MW_0)$. With these notations, M does not depend on the amount of initial assets W_0 .

The parameterisation of the model is very close to the one of the general equilibrium model of Section (2) (see Oliveira Martins *et al.* (2005) for more justification). The psychological discount rate ρ is set at 3 per cent. The risk-aversion parameter γ in the CRRA utility function is assumed to be equal to 1.33 (with an implied intertemporal substitution elasticity of 0.75). Survival probabilities P_t in each country are computed using United Nations (2002). These data are available only up to 100 years of age. The model assumes that they decline linearly reaching zero at age 110. The real interest rate r , is exogenous and supposed equal to the discount rate, *i.e.* 3 per cent. Alternative scenarios have been tested with $r = 3$ per cent and $\rho = 2$ per cent and yield the same orders of magnitude. In case of a real interest rate above the discount rate, the value of M would increase in each country only by a few percentage points. Eventually, the value of λ in the non-fair annuity scenario ($\lambda < 1$) is set at 0.85 for all countries, in line with Finkelstein and Poterba (2004) on UK data and Mitchell *et al.* (1999) on US data.

Figure 7 shows the results of setting the value of λ at 0.85 to take into account the effects of asymmetric information on the pricing of annuities. In all countries, the impact on welfare of purchasing a “non-fair” annuity would still remain sizeable. An individual with no annuity should have accumulated 10 per cent to 30 per cent more assets upon retirement to reach the same level of utility as an individual who bought a “non-fair” annuity.

The model implies that in countries with higher life expectancies (*e.g.* Japan, Spain, Sweden and Switzerland) individuals would experience lower welfare gains from buying an annuity, independent of whether the annuity is “fair” or “unfair”.⁵ Another implication of the model is that welfare gains of buying an annuity are likely to increase with aversion to risk. Higher risk aversion leads to higher saving for precautionary motives, increasing therefore the gains from buying an annuity.

Figure 7. Welfare gains from buying an actuarially “unfair” annuity¹


1. Increase in the stock of capital at retirement age needed to remain indifferent between buying an annuity or not. Retirement age is 65 and λ is set at 0.85. The discount rate is set equal to the real interest rate at 3 per cent.
 2. The relative-risk aversion coefficient is set at 2.0.
 3. The relative-risk aversion coefficient is set at 0.9.
- Source: OECD calculations.

In the light of these calculations, the negligible development of voluntary annuity markets in OECD countries is puzzling. The cost of asymmetric information cannot by itself account for this phenomenon. Annuities provide a valuable service by insuring households against the longevity risk, which legitimates a lower rate of return than with other financial instruments. The model suggests that this welfare gain may well dominate the detrimental impact of asymmetric information.

Friedman and Warshawsky (1988 and 1990) have argued that the underdevelopment of these markets may be related to bequest motives. Annuities do not allow for leaving bequests. These authors extend Kotlikoff and Spivak's (1981) model to incorporate bequests in the household's utility function. They also take into account the existence of a PAYG regime providing compulsorily public annuities, *i.e.* pensions. Their model suggests that, in the case of "non-fair" annuities, a reasonable degree of bequests can translate into a low demand for annuities.⁶ Nonetheless, their results are critically dependant on a low value for the risk-aversion parameter. This raises some doubts about the sensitivity of their model.

Overall, it remains relatively unclear whether accounting for a bequest motive in annuity schemes could have a decisive detrimental effect on the demand for annuities and foster the development of an annuity market. In principle, there is no conflict between the demand for annuities and bequests: by reducing longevity risk, the purchase of annuities reduces the need for precautionary savings and may increase the ability to leave voluntary bequests. Further academic research seems required on this issue.

Some possible implications for structural policies

Governments could support the development of annuities by allowing some market segmentation. Indeed, annuities prices are often computed on the basis of uniform – notably, undifferentiated by gender – and compulsory tables defined by regulators or governments. Allowing for specific contractual clauses in annuity contracts would also enable insurers to extract some more information from annuitants about their survival probabilities. A guaranteed period clause would ensure that if the annuitant dies before this period is over, periodic payments over the remaining number of years to fulfil this period are paid to heirs. This clause would introduce a kind of bequest mechanism and would be relatively more appealing for individuals with low survival prospects. A capital protection clause would ensure that the discounted value of periodic payments paid by the insurers to the annuitant would have to be at least equal to the amount of capital sold at the beginning of the contract. This clause also reveals information about survival expectations by annuitants. Insurers can then adjust annuity prices accordingly, segmenting the market and lowering the level of asymmetries of information (Finkelstein and Poterba, 2002). However, regulators should ensure that the pricing of these clauses does not depress significantly annuities purchases by poorer individuals with low survival expectancy.

On the demand side, a compulsion approach may appear accurate especially in the context of the development of pre-funded pension schemes. This compulsion policy would require that part of the accumulated capital in pre-funded regimes must be transformed into an annuity at retirement. This would diminish

asymmetries of information since annuities would be priced on the basis of the average survival probability in the total population (Finkelstein and Poterba, 2002). However, it could also create a cross-subsidisation from shorter-lived (often poorer) individuals to (often richer) individuals with longer survival prospects (Dushi and Webb, 2004), an issue requiring careful monitoring. Where pension funds are organised along occupational lines and provide annuities such concerns may be lower.

Apart from annuities, reverse mortgages may be another financial instrument of a particular interest in an ageing and more capitalistic context. A reverse mortgage is a loan against the borrower's home that has not to be paid back as long as the borrower lives. It reverses the scheme of a traditional ("forward") mortgage. In a standard mortgage, remaining debt diminishes over time and home equity rises along with regular payments from the borrower to the bank. In a reverse mortgage, debt rises (because interest compounds) and home equity shrinks along with regular payments from the bank to the borrower. When the borrower dies, the reverse mortgage becomes payable. The reimbursement is usually financed by selling the house. If positive, the difference between the value of the home sold and the amount of debt to be reimbursed at the time of death can be transmitted to the heirs.⁷ If negative, legislation imposes that the lender, when seeking repayment of the loan, does not have legal recourse to anything other than the home value. Banks fix the amounts of periodic payments taking into account this "non-recourse limit", the market interest rates, the survival probability of the borrower and the home value.

Reverse mortgages make it possible for older individuals to turn a significant fraction of their illiquid real estate assets into cash without selling them. The liquidity of assets they allow for is crucial to ensure an efficient use of accumulated capital during the retirement period. Contrary to standard annuities, it is also possible to leave bequests out of these financial instruments.

Up to now, new issues of reverse mortgages in the US and UK have been limited, reflecting perhaps a lack of financial literacy of households to cope with these instruments. Nonetheless, recourse to reverse mortgages is developing. Encouraging this development would broaden the supply of financial products and help households to cope more efficiently with longevity risk. Governments could provide insurance for bankers against the risk associated with the non-recourse limit mentioned above. Provided the market is competitive, the cost of reverse mortgages for households would thereby diminish.

Notes

1. The structure of the model did not enable a parameterisation on UK data, mainly because the UK pension system is weakly earnings-related.
2. See Oliveira Martins *et al.* (2005) for more details.
3. As the labour market is exogenous, age-specific participation rates of workers above 50 years of age is assumed to increase in line with the changes in the age of retirement. For instance, in 2045 participation rates of 60 year old workers are the same as those of 55 year old workers in 2005, and so on.
4. Mitchell *et al.* (1999). find a value of 38.6 per cent on US data with a risk-aversion parameter of 2.
5. This is because the difference between life expectancy and the maximum lifetime horizon (fixed in the model at 110 years old) declines in the model. With the period of uncertainty shrinking, the amount of precautionary saving needed to meet the longevity risk also declines.
6. The “reasonable degree” of bequest results from the assumption of an expected bequest at time of death between two to four times the level of consumption in the last year of life. For different orders of magnitude, see Menchik and David (1982).
7. To be eligible for most reverse mortgages, the borrower must currently be at least 62 years old.

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Résumé : L'impact agrégé et structurel du vieillissement sur les marchés de capitaux : évaluations quantitatives

Dans les prochaines décennies, le vieillissement va modifier les tendances de long terme de l'offre ainsi que de la demande de capital. Cet article procède à des évaluations quantitatives des effets du vieillissement sur les marchés de capitaux de quatre grands pays de l'OCDE (Allemagne, États Unis, France et Japon). Utilisant un modèle d'équilibre général à générations imbriquées, il indique que le vieillissement pourrait renforcer l'intensité capitalistique et abaisser les taux d'intérêt à l'avenir (de 25 à 100 points de base à long terme, en fonction des caractéristiques des réformes des régimes de retraite). Dans ce contexte, les craintes relatives à une « fonte des actifs » due au vieillissement est sans doute exagérée. Le modèle indique aussi que l'accumulation individuelle de capital devrait s'accroître à l'avenir et nécessite des changements structurels des marchés de capitaux. Les ménages vont devoir de plus en plus se couvrir contre les incertitudes liées à l'évolution future des prix des actifs, des taux de rentabilité du capital ou de l'espérance de vie. Cet article évalue les gains de prospérité dont un particulier peut profiter en faisant l'acquisition d'un produit de rente au moment de son départ en retraite. En effet, l'achat de tels produits, même s'il n'est pas actuariellement juste, peut accroître sensiblement le bien être des ménages. Ces résultats appellent des mesures en faveur du développement des rentes viagères et des viagers hypothécaires.

Abstract: Pension Funds for Government Workers in OECD Countries

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 occupational complementary pension funds for civil servants. In many OECD countries these funds are among the largest in terms of assets and number of participants and constitute an important share of financial assets. Nonetheless, civil servants' pension funds are exposed to particular risks related to the multiple roles played by the state which 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. This paper analyses these risks in light of the experiences of Australia, Canada, Japan, the Netherlands and the United States and identifies good practices on how to avoid or mitigate them.

Pension Funds for Government Workers in OECD Countries*

I. 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 a 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,

* This article was prepared by Vinicius Carvalho Pinheiro, Senior Programme Officer at the Social Protection team of ILO's International Training Centre, Turin, Italy, during his assignment as consultant seconded by the Brazilian Government to the Financial Affairs Division of the OECD Directorate for Financial and Enterprise Affairs. A previous version of this paper was presented at the December 2004 session of the OECD Working Party on Private Pensions. The author would like to thank Juan Yermo, Fiona Stewart and Stephen Lumpkin for their comments.

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.

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) of Canada; the Federation of National Public Service Personnel Mutual Aid Associations (FNPSMAA) and the Pension Fund Association for Local Government Officials (PFALGO) of 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 on their web sites.

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.

II. 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).

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.

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)	Korea	Australia	Argentina
China	India	Austria	(federal and some provinces)
Colombia	Hong Kong, China	Canada	Chile
Brazil	Indonesia	Costa Rica	Czech Republic
Belgium	Jordan	Denmark	Hungary
France	Malaysia	Finland	Poland
Germany	Philippines	Iceland	Uruguay
Greece	Spain	Italy	
Ireland	Singapore	Japan	
Luxemburg	Thailand	Netherlands	
Mexico	Chinese Taipei	Norway	
Portugal	United States	Sweden	
Peru	(some states' schemes)	Switzerland	
Turkey		United States (federal workers and some states' schemes)	
		United Kingdom	

Source: OECD.

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 are traditional complementary schemes 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.

III. 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.

IV. 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 USD 3 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.

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

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

	PSS	OMERS	ABP	FNPSMAA ¹	PFALGO ²	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

1. 2002.

2. Including deferred members.

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

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 the 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.

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

**Table 3. Contributions for government workers pension plans
in selected OECD countries – 2003**

	PSS	OMERS	ABP	FNPSMAA ¹	PFALGO	CALPERS
Employer	15.4% (notional)	Match employee contribution	17.25%	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%

1. The contribution rates will rise annually from October 2004.

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

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 per cent 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

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 www.calpers.ca.gov).

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.

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).

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 (Table 5).

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 1 900 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

Table 4. **Outsourcing functions in the civil servants pension funds**

Pension funds main functions	PSS	OMERS	ABP	FNPSMAA 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.

Table 5. Codes for pension funds managers

	PSS	OMERS	ABP	FNPSMAA 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.

and disclosure of energy use. According to recent polls, 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 workplace; 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

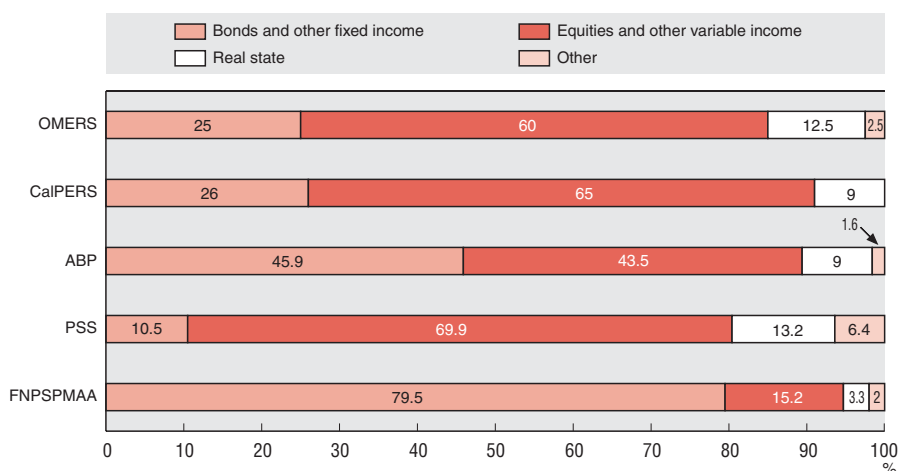
All surveyed pension funds have written investment policies revised annually with participation by external advisors. Asset liability methods are used by ABP, CalPERS and OMERS and assets are evaluated by marked-to-market methods and book value.

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.

OMERS' investment strategy for the next 10 years combines reducing the exposure to public stock and bond markets, maintaining a large real estate portfolio

Figure 1. **Portfolio allocation of selected civil servants pension funds in the OECD – 2003**



Source: OECD Questionnaire on Civil Servants Pension Funds.

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 FNPSPMAA 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.

V. 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.

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Résumé : Les fonds de pension pour les salariés de l'administration publique dans les pays de l'OCDE

Ces dernières années, on a assisté à un mouvement d'harmonisation des politiques des retraites des salariés des secteurs privé et public, avec l'introduction de régimes professionnels de retraite complémentaire par capitalisation pour les fonctionnaires. Dans de nombreux pays de l'OCDE, ces fonds de pension comptent parmi les plus importants en termes d'actifs et de nombre de participants et ils représentent une part importante des actifs financiers. Néanmoins, les fonds de pension des fonctionnaires sont exposés à des risques particuliers liés aux rôles multiples que joue l'État, tout à la fois promoteur, autorité de tutelle, autorité de contrôle, prestataire de service, agent fiduciaire et destinataire des investissements des fonds de pension. Dans le cas de ces fonds, on peut se trouver en présence de problèmes spécifiques d'agence liés à l'administration publique qui diffèrent de ceux que l'on analyse fréquemment dans le secteur privé. Cet article analyse ces risques à la lumière des expériences de l'Australie, du Canada, des États Unis, du Japon et des Pays Bas et il définit les bonnes pratiques à suivre pour éviter ou atténuer ces problèmes.

Abstract: Guidelines for Insurers' Governance

On 28 April 2005, the OECD Council approved the Recommendation on Guidelines for Insurers' Governance. Guidelines were first endorsed by the OECD Insurance and Private Pensions Committee in collaboration and wide consultation with the 30 member countries' governmental experts in the insurance sector as well as the insurance and reinsurance industry. These guidelines were also deemed fully compatible and consistent with the OECD Revised Principles on Corporate Governance by its Steering Group in October 2004.

Recent scandals have revealed huge financial irregularities and highlighted the need for insurers and their watchdogs to improve governance standards in order to strengthen investors' and customers confidence in the insurance industry. The 12-point Guidelines for Insurers' Governance provide governments and the insurance and reinsurance industry including mutual entities with a roadmap to do this and thereby better protect policyholders and shareholders. They include specific proposals for:

- The structure and responsibilities of the board, with as its primary objective the protection of shareholders and policyholders.
- The integrity and accountability of board members, who should be legally responsible for their actions and decisions.
- Strict internal control and reporting systems, which take into consideration insurance specificities and complexities.
- The appointment of an independent, external auditor to certify an insurer's accounts at least once a year and who has the power to alert regulators to irregularities or criminal violations. The role of the actuary is also confirmed as essential for the governance of insurers.
- Clear and timely disclosure to stakeholders (such as policyholders, shareholders, regulators and supervisors) of an insurer's financial position and of its exposure to financial and technical risks.
- Access to prompt redress through the courts or regulators or the setting up of alternatives such as internal dispute procedures and independent arbitrators.

Guidelines for Insurers' Governance*

Introduction

The OECD Ministers agreed in 2002 “that implementation of best practices in corporate and financial governance entails an appropriate mix of incentives, balanced between government regulation and self-regulation. [They] seek to improve such governance to enhance transparency and accountability and thereby strengthen investor confidence and the stability and resilience of financial markets”.

The emphasis on financial governance as well as broader corporate governance reflects both the essential role of financial markets in the economy and the distinct risks and responsibilities of the sector. The emphasis on governance is because, even in highly regulated sectors, regulation alone cannot achieve the good practice necessary for integrity and effectiveness. Companies themselves must develop internal rules and systems in order to reach these goals, but governments and international bodies can provide guidance on these rules and systems.

When discussing its 2003-2004 programme of work, the OECD Insurance Committee agreed to take up the challenge to produce Guidelines for Insurers Governance. This work was intended to capture the specificities of the governance of insurers and to complement the revised OECD Principles of Corporate Governance.

The governance of insurers must address sector-specific issues related, for instance to the responsibilities of fiduciaries, the rights of beneficiaries/policyholders, or the non-corporate (*e.g.* mutual insurers) nature of some insurers. In addition, all insurance entities are exposed to various technical (*e.g.* actuarial, underwriting and investment risks) and non-technical risks. The insurance business is also characterised by complex principal-agent relationships, as well as asymmetry in market power and information among various stakeholders. Some agency problems are common to all insurance entities, while others arise in the context of particular sub-sectors, namely life insurance, non-life insurance and reinsurance.

* These guidelines were endorsed as a Recommendation by the OECD Council on 28 April 2005. They are fully compatible and consistent with the revised OECD Principles on Corporate Governance. These guidelines can also be found on the OECD web site, in English (www.oecd.org/dataoecd/19/10/34799740.pdf) and French (www.oecd.org/dataoecd/19/11/34799905.pdf).

Various aspects of the legal and regulatory infrastructure for insurance in OECD countries address these risks. For instance, the underwriting of insurance risks is restricted to licensed insurance entities. Prudential regulation and supervision, solvency requirements and external oversight enhance the protection of policyholders against conflicts of interests and cover default risks.

In view of this extensive regulation and oversight of the insurance sector, the OECD Insurance Committee and its Working Party on Private Pensions pursued two main objectives in drafting the Guidelines:

- to provide complementary guidance that would help the sector to enhance the protection of policyholders and/or shareholders beyond the protection already provided by existing regulation and supervision; and
- to develop complementary guidance specifically directed to the insurance sector that would supplement corporate governance rules generally applicable to corporations.

In this perspective, the Guidelines offer direction, but do not constitute either a binding code or a standard. Besides, the Guidelines are sufficiently flexible to take into account the specific agency conflicts that are common to the sector, the unique characteristics of each branch of activity, and the existence of various forms of ownership. Specific guidelines are provided for mutual insurers in view of their non-corporate nature. The Guidelines also highlight the particular importance of the actuarial function in the governance structure of insurers.

The Guidelines are directed to the insurance community, including stock companies, mutual insurers or any other kind of ownership, insurers and reinsurers. They draw on the experience of the Member countries and other organisations represented in the Committee. In particular, the Committee took careful note of and refers to the International Association of Insurance Supervisors' (IAIS) compilation of Insurance Core Principles on Corporate Governance that was published in January 2004, as well as other IAIS work and comments.

The Guidelines also benefited from the work and revision of the OECD Principles on Corporate Governance, which they complement. They are also fully compatible and consistent with these revised Principles. Accordingly, the Committee has understood and used the term "governance" in the Guidelines as the term is formulated in these Principles.

In addition, the Guidelines presented here have drawn from the work related to the Guidelines for Pension Funds Governance.¹ A number of specificities of the insurance sector are comparable to those of pension funds, such as the insurer's

fiduciary role *vis-à-vis* its policyholders, the importance of the whistle-blowing functions of auditors and actuaries and the technical complexity of the products sold.

The Guidelines as such are articulated around three main sections related to 1) Governance structure, 2) Internal governance mechanisms and 3) Stakeholders' protection. Each guideline is numbered and headed by a statement followed by a series of recommendations and specifications in italics. The Guidelines are also complemented by annotations, providing some background information on their rationale and focusing on more specific insurance issues, *i.e.* actuaries and mutual insurers.

Recommendation on Guidelines for Insurers' Governance

THE COUNCIL,

Having regard to Article 5b) of the Convention on the Organisation for Economic Cooperation and Development of 14 December 1960;

Considering that the OECD Ministers agreed in 2002 “that implementation of best practices in corporate and financial governance entails an appropriate mix of incentives, balanced between government regulation and self-regulation. [They] seek to improve such governance to enhance transparency and accountability and thereby strengthen investor confidence and the stability and resilience of financial markets”;

Considering that the integrity of financial institutions depends not only on regulation and supervision, but also on the quality of governance practices within financial institutions;

Considering that the specificity of the risks and responsibilities faced by insurance providers call for specific guidance on governance in addition to the more general standards provided by the revised OECD Principles of Corporate Governance;

Considering that the Guidelines for insurers' governance (hereinafter called “the guidelines”) complement the revised OECD Principles of Corporate Governance and that the Steering Group on Corporate Governance in October 2004 expressed the view that the Guidelines on Insurers Governance are fully compatible and consistent with the revised Principles;

Considering that a number of specificities of the insurance sector are comparable to those existing for pension funds, such as the insurer's fiduciary role vis-à-vis its policyholders and the technical complexity of the products;

Considering that these guidelines are meant to provide guidance to the insurance community as a whole including stock companies, mutual insurers or any other kind of ownership, insurers and reinsurers internationally – thereafter designated as “insurance entities” or “insurers”;

Considering that the Insurance Committee has elaborated these Guidelines on the basis of experiences of Member countries and relevant international institutions, and organisations, in particular the International Association of Insurance Supervisors;

Recognising that evolutions in the insurance community or/and in the revised Principles of Corporate Governance may call for further updating and adaptation of these guidelines;

On the proposal of the Insurance Committee;

I. RECOMMENDS that Member countries invite public authorities and insurance entities to ensure an adequate and efficient governance framework for insurers, having regard to the contents of the Annex to this Recommendation of which it forms an integral part.

II. INVITES Member Countries to disseminate these guidelines among public and private insurers.

III. INVITES non-Member Economies to take account of the terms of this Recommendation and, if appropriate, to adhere to it under conditions to be determined by the Insurance Committee.

IV. INSTRUCTS the Insurance Committee to exchange information on progress and experiences with respect to the implementation of this Recommendation, review that information and report to the Council within three years of its adoption, or sooner, and, as appropriate, thereafter.

Annex: Guidelines for Insurers' Governance

The following guidelines are applicable to any insurance entities (hereinafter called either “insurer” or “insurance entity”) licensed to underwrite life, non-life and reinsurance policies. They are designed in light of the overriding objective of an insurance entity, which is to provide benefits to the insured in accordance with the contracts concluded with them, and to satisfy its shareholders (participating policyholders in the case of mutual insurers). Having regard to the specificity of reinsurance business, some specific recommendations as regards stakeholders' protection, may not be fully applicable to reinsurers.

These guidelines are non-binding. They are only meant to provide guidance and to serve as a reference point taking into account the specificities of the governance of insurers, for the OECD and non-OECD members' policy makers and for their insurance industry as well as its main stakeholders. As such, policy makers and market players may apply them if they consider it opportune, through diverse regulatory frameworks and according to the specificities of their jurisdiction (either through corporate law, or rules that specifically apply to the insurance industry such as Insurance Acts, and/or through codes of conduct set up by the private sector).

These guidelines are consistent and compatible with the revised OECD Principles on Corporate Governance, which they complement.

I. Governance structure

The governance structure must establish an appropriate division of administrative and oversight responsibilities, stipulate and delineate the qualifications and duties of persons bearing responsibilities, and protect the rights of policyholders and shareholders or “participating policyholders”.¹

Guideline 1. Identification of responsibilities

Within an insurance entity, the responsibilities of every corporate body must be stipulated clearly.

1. The term “participating policyholders” refers hereinafter, for instance, to the particular status of policyholders/shareholders in the case of insurers taking a mutualist or cooperative form.

Likewise, the main factors which may have a significant influence on governance should be ascertained and made public. Accordingly, the form of ownership and any provisions for changing it, the scope of business, the internal governance structures and the entity's primary objectives must be set out clearly in its statutes, by-laws or contracts or in documents associated with these.

Guideline 2. Board(s) structure

The structure of the governing body, whether single (board of directors) or dual (having a board of directors and a supervisory or executive board), should be defined, along with the responsibilities of each entity. These responsibilities should be consistent with the insurer's core objective of providing benefits pursuant to its contracts. The governing body is ultimately responsible and should not be allowed to completely absolve itself of its responsibilities by delegating certain functions to subcommittees or external service providers.

Accordingly, the governing body should retain the responsibility for monitoring and oversight of those service providers or subcommittees.

Guideline 3. Functions and responsibilities

The Board's main responsibilities should cover those functions essential to good governance, i.e.:

- *reviewing and guiding the strategy of the insurance entity, including reinsurance strategies, major plans of action, risk policy related to the main insurance risks and annual budgets; approving the pricing strategy, setting performance objectives, overseeing auditing and actuarial functions, and other oversight structures and monitoring the administration of the insurance entity in order to ensure that the objectives set out in the fund by-laws, statutes or contracts, or in documents associated with any of these, are attained (e.g. diversified asset allocation, cost-effectiveness of administration, etc.);*
- *selecting on a fit and proper basis, compensating, monitoring, and where necessary replacing staff with operational responsibilities as well as external service providers which can play an important function in the management of insurers (e.g. asset managers, actuaries, auditors, etc.);*
- *monitoring and managing potential conflicts of interest between board members and shareholders, including misuse of the entity's assets and abuse in related party transactions;*
- *ensuring the compliance of the activities of the entity with the Law and in particular the Insurance Law (e.g. investment regulations, reporting and disclosure requirements, etc.);*
- *monitoring the effectiveness of the governance practices under which it operates and making changes as needed.*

Guideline 4. Composition and suitability

The number of board members, how they are selected and a fair balance between executive and non-executive directors should be specified in the by-law or legal status of the entity or in documents associated with any of these.

A sufficiently high proportion of directors should be non-executive. Such requirement may be replaced by the existence of a bicameral structure or a supervisory body. In both cases, concerned members should be independent of influences that may limit their capacity to provide objective oversight of the entity. As regards to mutual insurers with a single board structure, specific control may be needed to compensate the limited control exercised by participating policyholders.

The term of office of board members and how they are elected should also be specified.

Board members should have the necessary qualification to act in accordance with their responsibilities and functions and to ensure a high level of integrity and professionalism in managing the insurance entity.

Members of the governing body should be subject to minimum suitability standards and possess the appropriate integrity, competence, experience and qualifications. Conviction for fraud or other economic crimes, the fact of being subject to disciplinary restrictions by a professional body, gross mismanagement of another entity that led to significant civil penalties, personal bankruptcy and the consequences of an administrative decision implying the disqualification of a member of the governing body should be considered clauses for disqualification.

Guideline 5. Accountability

Board members are accountable to the entity's shareholders and/or policyholders, or participating policyholders and/or to the competent authorities. To ensure this accountability, board members are legally liable for their actions and decisions.

The accountability of the governing body requires: regular meetings of the governing body; information on decision-making power in the governing body; appropriate disclosure of the material decision reached in these meetings which concern the relations with insured and shareholders (or participating policyholders); reporting of information about the operation of the insurance entities to the supervisory authorities; transparent selection mechanisms for the members of the governing body; appropriate succession planning processes.

The selection and succession planning structure should deal with the term, appointment/election and removal of members of the governing body of the insurance entity.

Guideline 6. Actuary

The insurer should nominate an actuary who reports to the Board and management – at least in the case of a life insurance entity – and who should be able to act in an independent way. The use of actuarial standards in non-life insurance entities should be promoted as well. This actuarial function should preferably be fulfilled by an appointed actuary. It may also be performed by any manager of the entity who should have the possibility to report directly to the board, or by an external consultant.

The actuary's responsibilities, and any advisory role *vis-à-vis* the board or the management as well as his/her rights and obligations, should be set forth clearly. As soon as the actuary realises, on performing his/her professional or legal duties, that the entity does not or is unlikely to comply with the appropriate requirements, and depending on the general regulatory framework, he/she must be able to so inform the board or the management and the external auditors ("*whistle-blowing*" function). The board should have access to the actuary as well. In the use of its whistle-blowing functions the appointed actuary should be protected by the applicable insurance legislation or regulation of the jurisdiction or by the by-laws and status of the entity and if possible of the professional body.

The actuary should be subject to strict qualification and suitability standards in compliance with the supervisory framework of the concerned jurisdiction.

Guideline 7. External auditors

An external auditor *independent* from the insurance entity, its management and its board(s) should be appointed to certify the entity's accounts on at least an annual basis. His/her term of office should be limited and renewable under specific conditions.

The auditor should be able to alert the competent authorities promptly of any event that could seriously affect the entity's financial position or the organisation of its administration or its accounting and of any criminal violations and material irregularities ("*whistle-blowing*" function).

The auditor should be able to make use of actuarial skills, whether internally or externally. In the case where the appointment of an actuary is required by the jurisdiction, he/she should be able to report to the auditor.

The auditor should be subject to strict qualification and suitability standards in compliance with the supervisory framework of the concerned jurisdiction.

II. Internal governance mechanisms

Insurance entities should have appropriate control, communication and incentive mechanisms that encourage good decision-making power and timely execution, transparency, and disclosure and ensure regular review and assessment, having regard to the branches of business operated. These mechanisms should be tailored to the protection of policyholders, beneficiaries and shareholders (or participating policyholders).

Guideline 8. Internal controls

Appropriate controls should be put in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives for each class of business that are set out in the insurers' by-law, statutes, contracts or in documents associated with any of these, and that they comply with the law.

Such controls should cover all basic organisational and administrative procedures, depending upon the scale and complexity of the class of business. These controls mainly under the responsibility of the board will include performance assessment, compensation mechanisms, information systems and processes, and (asset and liabilities) risk management. The board should also ensure that management takes prompt action to correct any material control problems that emerge from these reviews and that there is a board process in place to follow up on progress made to correct deficiencies. Useful inputs into these controls include management reports, internal and external audit opinions and audit reports on the financial statements, reports of the appointed actuary, and views and observations of the supervisory authorities as well as views, solicited by the board, of the entity's external and internal auditors and legal counsel.

Guideline 9. Reporting

Reporting channels between all the persons and entities involved in the administration of the insurer should be established in order to ensure the effective and timely transmission of relevant and accurate information.

Processes need to be put in place to ensure that the members of the governing body receive appropriate, timely, accurate, complete and easily comprehensible information so they may discharge their responsibilities effectively, in accordance with the code of conduct, and ensure that the delegated responsibilities are fulfilled. For its part, the governing body should ensure that actuaries, asset managers, consultants and other professional service providers also receive relevant and accurate information in a timely manner in order to ensure they carry out their duties as established by the governing body.

III. Stakeholders' protection

The governance framework of insurance entities should ensure an appropriate protection of the rights of stakeholders through disclosure and redress mechanisms and the compliance with the basic rights of shareholders or participating policyholders in the case of mutual insurers.

In the case of entities taking a corporate form, the principles II and III in the OECD revised corporate governance principles, dedicated to the rights of shareholders and key ownership functions and the equitable treatment of shareholders, should be referred to.

Guideline 10. Protection of participating policyholders in the case of mutual insurers

In the case of mutual insurers, the governance framework should also accurately protect the rights of participating policyholders, accordingly:

1. Members may: 1) waive their interests in the entity through ending their insurance contract, subject to the terms and conditions of that contract; 2) participate and vote in general meetings, whether directly or indirectly; a general meeting may also be held in the form of a meeting of members' representatives, the section assembly. If this is constituted by direct elections, all members of the entity have voting rights. Co-option through the meeting of member's representatives is allowed; 3) obtain relevant information on the entity on a timely and regular basis; 4) elect members of the board; or in the case of a bicameral structure elect the members of the supervisory board who then appoint the members of the board; and 5) approve proposals of the board of rebates, supplementary contributions and distribution of surplus earnings.
2. Members may participate directly, or through the meeting of representatives and be sufficiently informed about decisions concerning fundamental changes to the entity, such as: 1) amendments to the statutes (demutualisation, re-organisation by creating a mutual holding entity, etc.); 2) authorisation to issue participating securities or to issue bonds or subordinated instruments if this decision implies some material impacts for members; 3) the transfer of all or part of the policy portfolio.
3. a) Where no meeting of members' representatives exists, members should have the opportunity to participate effectively and vote in general meetings

and should be informed of the rules, including voting procedures, that govern general meetings:

- *Members should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.*
- *Opportunity may be provided for members to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.*
- *Members may be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.*

b) Where a supervisory body comprising member representatives exists, the role of the members within the general meetings mentioned under item a) should be transferred to the members' representatives and their general meeting.

Guideline 11. Disclosure

Insurance entities should disclose relevant information on a clear and timely basis in order to give stakeholders (including policyholders, shareholders or participating policyholders, supervisory authorities, etc.) a proper view of their business activities and financial position and to facilitate the understanding of the risks to which they are exposed. However, information on risk management procedures should be provided with due respect of data protection and confidentiality obligations and should avoid limiting the competitiveness of insurance entities.

Disclosure should include, but not be limited to, quantitative and qualitative material information on the financial and operating results of the entity; financial position; financial performance; and a description of risk exposures and how they are managed; the basis, methods and assumptions upon which information is prepared (including comments on and the impact of any changes); management and corporate governance.

In addition, information transparency towards policyholders should cover inter alia information on the products including the associated risks, benefits, obligations and charges under the contract; other matters related to the sale of insurance policies including possible conflicts of interest with existing potential policyholders.

Guideline 12. Redress

Policyholders and participating policyholders should be granted access to statutory redress mechanisms through at least the regulatory/supervisory authority or the courts, which can assure prompt redress.

In addition, the setting up of alternative redress channels, such as internal dispute procedures and independent arbitrators or ombudsmen, should be encouraged. An arbitrator may be set up by the industry itself in order to encourage public confidence and maintain efficient business practice.

Annotations to the Guidelines on Insurers' Governance

I. Rationale for the guidelines

Regardless of the legal or ownership structure of insurers, all insurance entities are exposed to various technical (*e.g.* actuarial and underwriting risks and investment risks) and non-technical risks. In addition, the insurance business is characterised by complex principal-agent relationships, as well as asymmetry in market power and information among various stakeholders. Some agency problems are common to all insurance entities, while others arise in the context of particular sub-sectors, namely life insurance, non-life insurance and reinsurance. Various aspects of the legal and regulatory infrastructure for insurance in OECD countries address these risks: For instance, the underwriting of insurance risks is restricted to licensed insurance entities. Prudential regulation/supervision, solvency requirements and external oversight enhance the quality of protection for policyholders against conflicts of interests as well as cover default risks.¹ Considering this rather extensive regulation and oversight of the insurance sector, the drafting of guidelines dedicated to the governance of insurers should focus on two main issues: what complementary guidance could help this sector in enhancing the protection of policyholders and/or shareholders in addition to the protection already provided by the regulation and supervision in place, and what complementary guidance specifically dedicated to the insurance sector could supplement corporate governance rules generally applicable to corporations. To these ends, the governance framework for the insurance business must be well-defined, but sufficiently flexible to take into account the specific agency conflicts that are common to the sector, the unique characteristics of each branch of activity, and the existence of various forms of ownership: stock companies, mutual structures as well as unique structures like Lloyd's.²

Agency conflicts within insurance entities

Like other categories of financial services, the insurance business is subject to potential conflicts of interest between owners and managers, but with an added potential conflict involving policyholders. The nature of the conflict varies depending on whether an entity is structured as a share company or as a mutual insurer.³ In the case of the former, there is the potential conflict of interest arising from the separation of ownership from control. Although the particularity of the insurance business adds a layer of complexity, this conflict is similar to what arises in the non-financial sector and is not elaborated upon further herein. With a mutual insurer, the roles of policyholders and “owners” (cooperatives) are

somehow combined, which should address any potential conflict between the need to build sufficient reserves to cover risks and the need to provide owners with an adequate return on their investment. However, as ownership interests (be it through a share or a policy insurance contract) in mutual insurers are non-transferable and non-negotiable (cooperatives), market control mechanisms such as the threat of takeover, the possibility of management oversight and guidance by a majority of shareholders, or the use of stock options as incentive measures, are limited, if not completely lacking. Thus, the discretionary power of management in mutual insurers may be more extensive than in stock companies, unless counterbalanced by some other control mechanisms. These limitations have to be taken into account when elaborating an appropriate corporate governance structure for mutual insurers.⁴

Another potential agency conflict arises from the marked *asymmetry of information* and power between policyholders and management.⁵ The complexity of many insurance products and the varying duration of contracts lend themselves to various interpretations regarding particular contract clauses and make comparing different insurance policies an arduous task. Information may not be reported in an easily understood fashion and individual policyholders may lack the expertise needed to sift through various technical parameters of contracts. Policyholders and insurance beneficiaries are also a dispersed group, with little power to compel management to take certain actions. Without appropriate governance standards and other safeguards, their options may be limited to choosing not to take out a policy, choosing not to renew a policy, or seeking legal redress, which may be sub-optimal and can entail high costs.

The problem is further complicated by structural changes in the financial services landscape. Mergers and acquisitions within the insurance sector and others combining insurance entities with other types of service providers have resulted in large financial groups with opaque structures. The increasing number of cross-holdings between financial institutions may tend to cloud the visibility of information on entity situations for policyholders and other non-specialists.

Specificity of life insurance, non-life insurance and reinsurance

In addition to the conflicts of interest common more or less to all insurance entities, other governance issues arise in the context of specific branches of activity. Some issues may develop in life insurance, some in non-life, and others in reinsurance.

Life insurance establishes contractual relations over a number of years between an insurer and the life policyholder or the latter's beneficiaries, which is similar in many respects to the fiduciary relationships of pension funds. Major problems of governance stem, *inter alia*, from an insurer's viability as a going concern,

and from the behaviour of its officers. Over a long period of time, many parameters of policy pricing may change, including mortality rates for the insured, returns on investments, and inflation. Given all these uncertainties, the potential for conflicts of interest between insured and insurer over the duration of a contract is non-trivial, in the absence of other types of countervailing controls.

In contrast to life insurance, most non-life insurance business⁶ is regarded as having a shorter cycle of operation, one to three years in the majority of cases. Consequently, the potential conflict of interest between policyholders and shareholders is less obvious than in the life business. The problems of governance with non-life insurers stem from information asymmetries between policyholders and insurers, and from the discretionary power of management. These two factors may lead management to make opportunistic short-term decisions that have adverse implications for policyholders and shareholders.

In the case of the reinsurance business, the insured are themselves insurers and, thus, in principle possess adequate information and expertise about the underlying products. Partly for this reason, reinsurers are less regulated and supervised than direct insurers in some jurisdictions whereas in others the rules of supervision (licensing, minimum solvency requirements, sanctions) are largely, if not exactly, the same as those applicable to direct insurers. Be that as it may, the international nature of reinsurers' operations makes it difficult for a single national authority to supervise them, which suggests a need for enhanced co-operation and co-ordination among different supervisors, as well as sound governance structures and internal control mechanisms for the reinsurers themselves.⁷ However, the fact that the asymmetry of information is less an issue between insurers and reinsurers than between standard consumers and insurers should be kept in mind when interpreting the guidelines concerning the protection of stakeholders.

More generally, the complexity of the insurance business has entailed in most OECD countries the development of a specific function – the actuary – in order, *inter alia*, to control and assess the solvency of insurers' activities and the accuracy of technical provisions. Although the specific position and duties of actuaries vary across jurisdictions, the role of the actuary in the corporate governance of insurers has become paramount in the life sector and is increasingly developing in the non-life sector in most OECD countries.⁸

The role of prudential regulation and supervision in the governance of insurers

Finally, as underlined earlier, the governance structure of insurers has to take into account the very specific and evolving regulatory framework within which their activities are performed. As in the rest of the financial sector and because of the role of insurance in the economy, its regulation and supervision have played a key

role in shaping its governance structures and mechanisms. Rules generally have been designed to prevent default and to protect the interests of policyholders, the insured and the beneficiaries of insurance contracts, as well as any third parties that may have direct claims against an insurer under an insurance agreement. The risk is that in the quest for safety and soundness, policymakers may impose rules that are overly restrictive or prescriptive and for years regulatory authorities effectively left only modest leeway to market mechanisms to counter conflicts of interest. This point is illustrated by the debate concerning the choice of a quantitative approach or a “prudent person” approach to regulation of the investments of life insurance entities.⁹ More recently, given the globalisation of the insurance industry and the convergence of the financial sector, prudential standards and the dissemination of information are being determined more and more at an international and/or regional level.

Good governance of insurers: a complement to the regulatory prudential framework

A strong prudential regulatory regime is at the forefront of the governance framework for insurers. A sound legal and regulatory environment helps to protect policyholders from most of the major conflicts of interest arising in the insurance sector, and, in particular, to maintain the sector's financial soundness. However, regulatory authorities must be cautious not to impose highly restrictive rules and wide-ranging prohibitions that severely restrict the discretionary powers of corporate executives. It is ultimately the Board's role and function to manage the entity and make appropriate commercial decisions. Criticism in the past about the restrictive nature and cost of regulation has led authorities in most OECD countries to tailor prudential regulation and supervision to the actual risks facing entities on a case-by-case basis. In practice, these changes in the approach to supervision and regulation typically give insurance executives more latitude to formulate and justify their strategies and to manage risk, and they underscore the importance of internal control mechanisms within insurance entities.

Some would argue that the more flexible approach to external supervision of insurers may not be sufficient on its own to prevent poor risk management and the chance that certain insurance entities will subsequently fail. Assuming the protection of individual policyholders is the aim of most regulatory provisions in the OECD countries, there is a need to supplement prudential supervision with appropriate standards of conduct and other governance mechanisms. In practice, the greater degree of flexibility on the part of (re)insurers' managers, along with the heterogeneity of regulatory provisions according to the branch of activity and of forms of ownership, has given rise to governance structures that are differentiated and sometimes lack adequate transparency *vis-à-vis* all stakeholder groups.

The relative opaqueness of the structures and mechanisms of the corporate governance of insurers – especially at times of crisis – is an additional risk factor that calls for a more systematic approach to guidelines on governance in the insurance sector.

II. Detailed annotations

Guideline 1. Identification of responsibilities

An insurance entity is generally established in accordance to statutes, by-laws or contracts. These documents should clearly define the legal form of the entity: corporation, mutual, co-operative, provident societies or Lloyd's, as well as the lines of business underwritten (life, non-life, reinsurance) and the main objectives of the entity. These objectives may vary according to both the legal form of ownership and the type of business. The responsibilities of any corporate body (board of directors, supervisory board, executive board and senior management) should be stipulated.

Guideline 2. Board(s) structure

Each insurance entity is directed by a governing body that is responsible for the operation and oversight of the insurance entity. This governing body may be single or dual. Actually in some cases it can be appropriate to split the operational and oversight responsibilities between a board of directors and a supervisory board that oversees the activities of the board of directors and elect its members.

The Board may also form Committees to perform defined tasks, primarily audit, risk management, compensation or nomination committees (but also financial or screening committees, etc.). If so, the committees' composition, responsibilities and resources *vis-à-vis* the general meeting and the board of directors (and/or the supervisory board) must be stipulated. The committees report to the Board on their activities and findings. The overall responsibility for delegated duties remains, however, with the Board.

Guideline 4. Composition and suitability

The requirement concerning outside directors may also be replaced by the existence of a bicameral structure and of a supervisory body as aforementioned, as far as this body also ensures an independent control on the Board's decisions and activities. Some country may wish to impose more stringent and precise rules requiring that a majority of directors be non-executive and independent of influences that may limit their capacity to provide objective oversight of the entity.

Besides, two cases need to be distinguished for mutual insurers. On the one hand, mutual insurers with basic structure where participating policyholders have non transferable rights and exercise a limited control on the board and, on the other hand, mutual insurers with bicameral structure.

In the former case, the limited power and control that is often exercised by dispersed participating policyholders that do not benefit from “stock market control” advocates for more oversight of the board activities and decision from independent agents like outside directors. For instance, in Belgium, there is an Agreement (that mutual insurers may apply or not), which states two outside directors should be part of the board of a mutual insurer. It should also be noted that there is a difference in the control that may be exercised by corporate policyholders (*e.g.* ship-owners), who may be very few and powerful, and numerous and possibly dispersed individual policyholders.

In the case of a bicameral structure, the governing body of mutual insurers is usually controlled by a supreme body which is composed, for instance, according to German Insurance Supervision Law, by an assembly of members or of elected representatives of members. This supreme body includes, *inter alia*, professional members that are meant to be a substitute to the control exerted by the markets in the case of stock companies. The establishment of this structure seeks to limit the discretionary power of managers compared to participating policyholders. Moreover, the existence of another independent body that oversees the decisions and activities of the board of mutual insurers may also be considered as a substitute to the existence of outside directors on the board.

For these two reasons, any requirements concerning the composition of mutual insurers' boards need to be adapted according to the particular circumstances of the jurisdictions and to the type of mutual insurers concerned.

Concerning the composition of the board in general, if the insurance entity has significant operations abroad, the board should include members with international experience, possibly also from abroad.

The disclosure of the amount of the compensation of the board members may also be considered in order to increase the transparency and responsibility of the board's functions.

The qualifications and experience required of the members of the governing body should depend on their responsibilities and functions in the board. In some OECD countries requirements are also set up by the law for outside directors. In other countries, the qualifications of outside directors are left to the appreciation of the insurance entity.

Where it lacks the expertise needed to make sufficiently informed decisions and assume its responsibilities, the governing body could be required to seek the advice of designated experts or professionals to perform those duties, although it should not transfer its responsibilities to such persons.

Members of the governing body should not be in an employment relationship with the supervisory and regulatory authorities. The by-law of the entity or any documents related to them should also address the multiplication of mandates.

The continuation of education and training of board members should, if required, also be ensured in relation to their respective responsibilities.

Causes of disqualifications include being subject to disciplinary restrictions by professional bodies such as disqualification by a national actuarial association or having restrictions placed on the types of entities that an auditor can overview.

Guideline 5. Accountability

Accountability over governance functions is particularly important in order to allow the insured and shareholders or participating policyholders and/or the supervisory authority to discipline the governing body or seek other means of redress in case of mismanagement.

In some OECD countries the board is only accountable to the supervisory authority and not to the policyholders. However policyholders may file a claim to the competent court if they are dissatisfied with the board's management of the insurer or of their contracts. In most others, the board is first accountable to its shareholders and policyholders.

Guideline 6. Actuary

Actuaries play a major role, *inter alia*, as experts in the risks incurred by the insurer, in controlling the quality of the information the insurer discloses to its owners or participating policyholders and to the supervisory authorities, and in protecting the insured. The degree to which the regulations in OECD countries determines the actuary's place and function varies, but the trend in recent years has mainly been towards a strengthening of their powers both in the life and non-life sectors.

Actually, the regulations of most OECD countries require that an entity operating in the life insurance market retain the services of an outside or in-house appointed actuary. However, it should be noted that another model than the appointed actuary has also been developed in a few countries. In this case, the

model of the appointed actuary is accurately replaced by a model where the function of the actuary is performed on the one hand by the top management of life as well as non life insurance entities who have generally – but not compulsorily – actuarial skills, and on the other hand by the supervisory authority whose staff also has actuarial skills. Nevertheless this model might be difficult to reproduce elsewhere since it requires a supervisory oversight with powerful means and well-qualified staff.

The model of the appointed actuary is also more developed in the life sector owing to the long duration of life insurance contracts and to the necessity to ensure an appropriate level of provisions over a longer period. The appointment of an actuary is therefore only required in the life sector in most OECD countries. However, the complexity of the insurance business in the non-life sector as well and the risks stemming from an asymmetry of information between management and shareholders/participating policyholders/policyholders, advocates for actuarial advice also in this line of business – at least in so far as suitably qualified actuaries are available in the concerned market. Accordingly, in non-life insurance, the role of the actuary has expanded in a number of countries in recent years and could be enhanced further in coming years.

Besides, the actuary's appointment may be subject to supervisory review. In this case, an unsatisfactory review can be sanctioned by removal. Removal may be required where the actuary fails to perform adequately the required functions and duties or does not meet eligibility or fit and proper criteria. The entity should generally notify the supervisor of changes in actuary staffing.

The actuary should also be appropriately qualified in respect of specific professional and personal requirements and in adequation with the supervisory framework of the concerned jurisdiction. In many OECD countries, there are explicit criteria regarding who may qualify for appointment as an actuary. These criteria may be based on qualifications, professional experience, competence and integrity and membership in a professional association or a combination of these elements. In some countries, the actuary is also submitted to a peer review process. Finally, the actuary should be able to operate its activities in an independent way. Independence of the actuary may be understood in different ways according to jurisdictions' circumstances, but in particular to avoid possible conflict of interest, it seems, for instance, preferable that the actuary would not be permitted to hold his/her position at the same time as being a chief executive officer.

In addition to the traditional role of calculating technical commitments and/or assessing the values of tied commitments, the solvency margin as well as the compliance with accounting rules, and depending on the regulations of the country in question, other tasks or advisory functions may also be assigned to the actuary

such as: solvency supervision, certification of documents sent to the supervisory authority, certification of the calculation of premium rates and technical provisions, advice to management, supervision of the distribution of profits to policyholders, accuracy of the risk assessment policies, suitability of reinsurance arrangements and of the investment policy, statistical inference and stress testing of the future financial condition of the entity. Moreover, these tasks and responsibilities can change over time, taking into account the availability of suitably qualified actuaries and the quality of the profession's organisation as well as the extent to which the actuary is subject to professional standards of practice, qualification standards and obligations on professional conduct.

One of the key trade-offs at stake in the appropriate fulfilment of the actuarial functions inside insurance entities lies in how to find the right balance between the actuary's independence in its assessment of the situation of an insurer and the appropriate management and board's responsibility and accountability. To this extent too much independence of the actuary might mean that the management or the board may too heavily rely on another agent – the actuary – to take decisions and responsibility in the management of the firm. On the other hand, reduced independence of the actuary may increase the discretionary power of the managers, or top managers, and limit his possibility to correctly gauge the risk exposure of the insurer and exercise, if relevant, his whistle-blowing function.

Considering both this complex relationship between the management of the insurer and the function of actuary and the necessity for insurance activities of this technical advice, any requirement concerning the role and the independence of the actuary should be adapted to the circumstances of the market, business culture, and means of the supervisory authority of a given jurisdiction. However, the whistle-blowing function should remain a basic function as far as it helps strengthening the confidence of the market and the authorities while enhancing the actuary's leeway.

Accordingly, some countries may deem it relevant to also require from the actuary nominated in one entity, as a second step of its whistle-blowing function, to report to the supervisory authorities in case the board or the management would not have taken remedial measures after his/her first warning. This possibility does not imply, however any sharing of responsibility of the actuaries' legal duties with the supervisory authority.

Attention may also be paid in the governance framework to the respective roles, functions and relationship of actuaries with external auditors.

Guideline 7. External auditors

The independence of the auditors has to be interpreted in the general context of the concerned jurisdictions. In this respect, insurance auditors should be specifically licensed by supervisory authorities in addition to complying with general statutory requirements. They are appointed by the governing body, the general meeting of the shareholders or meeting of member representation, if relevant.

In order to ensure and improve the independence of auditors, many countries have for instance banned or at least strongly restricted the possibility for auditors to provide other services to their clients than their core auditing activity. In the cases where such – limited – non-auditing activity is allowed, careful attention is generally paid to the assessment of the specific circumstances of this task and in particular to the nature of the service provided and the systems of safeguards put in place to avoid undesirable conflicts of interest. For instance, in some countries, these non-auditing services may be performed provided that the fact that the auditor is performing these activities and also the fee that is being paid for these services, are publicly disclosed.

An auditor's term of office renewal might be considered, for instance, provided the partner in charge of the entity can be replaced by another partner belonging to the same auditing company.

Insurance auditors, apart from their general statutory duties, should verify the compliance with supervisory laws, regulations and instructions.

External auditors whistle blowing functions do not imply that the supervisory authority share a responsibility with the specific certification function of the auditors.

Internal governance mechanisms

The scope and complexity of internal control measures will vary according to the type and size of the insurance entity. For instance, in the case of composite insurance entities, the internal controls should be split between life and non-life activities.

Reinsurers should also develop internal controls particularly tailored to the risks inherent to their lines of business. In particular, reinsurers should develop appropriate policies and procedures covering underwriting in the risks covered by the concerned policies, accumulation of exposures, provisioning (and particularly IBNR provisions), retrocession, contract conditions, contracts, and investments. A distinction could also be made between reinsurers of life business and reinsurers of non-life businesses. In the former case, as for life insurers the risks last over a longer period of time, this implies that many variables may evolve and have therefore to be taken into account in the risk assessment process.

*Stakeholders' protection***Guideline 10. Protection of participating policyholders in the case of mutual insurers**

As afore-mentioned in the annotations on the board structure, mutual insurers can be organised through two main forms, a simple structure and a bicameral structure. In the latter case, the views of members are indirectly represented through their board of representatives. This case is thus reflected in the text of the guidelines. It should also be mentioned that the content of this guideline may also need to be adapted to the scale of a mutual insurer's business.

Moreover, it should be noted that this guideline only addresses the protection of participating policyholders. However, in the case of some mutual insurers, there can be non-participating policyholders who have different positions in the governance structure with respect to the control of the insurer's management. In Belgium, for instance, most mutual insurers are so-called "impure mutuals", meaning that the insured have no manager's rights and typically may not participate in the general meeting or have that right only provided that their rate premium exceeds a certain amount set by the by-laws. However, these "impure mutuals" still retain the main characteristics and possible conflicts of the mutual insurers' structure in so far as no stock market controls limit the discretionary power of managers.

Besides, this guideline should also apply to stock companies operated on mutual grounds in Sweden. These are usually owned by other financial institutions or organisations and do not distribute profit to shareholders. Instead, their surplus is handled in the same way as in the case of mutual insurers. Besides, the federal regime in Canada provides participating policyholders, who are entitled to participate in the profit of a stock company by receiving dividends, rights to participate in the governance of an insurance entity, including rights to vote, make proposals and elect directors, in both mutual insurers and stock companies. Insurers issuing par policies must also meet certain regulatory requirements with respect to the par account.

Guideline 11. Disclosure

Disclosure may also include in some countries: major share ownership and voting rights; members of the board and key executives, and their remuneration; material issues regarding policyholders, employees and other stakeholders; significant strategic alliances and outsourcing arrangements between the insurer and third parties; future quantifiable potential of identifiable intangible assets (*e.g.* capital expenditures on research and development, investment in training and advertising campaigns).

Information transparency towards policyholders, *inter alia*, in the process of the sale of the insurance policies could also cover premiums, investment policy and returns (in the case of life insurance products with variable saving components).

Besides, it is worth mentioning that disclosure requirements for insurance entities are also being developed in the framework of the International Financial Reporting Standards by the IASB.

Guideline 12. Redress

Informal redress channels may offer many advantages, including the lower cost to consumers, and potentially, quicker resolution of the matter. Litigation, while potentially highly effective in sanctioning mismanagement, can be excessively costly for individual consumers, though it may be appropriate in the case where an entire group (*e.g.* an employment association) is affected.

Notes

1. Prudential regulation and supervision play a role at the various levels at which conflicts of interest can arise between insurers and the insured. Information asymmetry and risks of adverse selection when contracts are taken out, and throughout their lifetime, are being potentially reduced by the development of contract law, compulsory insurance and (prior or *ex post*) pricing review in the OECD countries. Risks or uncertainties regarding the insurer's capacity to meet its commitments over the long term, which characterise life insurance in particular, are limited by the development of regulations on licensing, fit and proper management, solvency and insurance entity investments. In addition, to preserve policyholder rights in the event of an insurer bankruptcy, many OECD countries have instituted general or specialised policyholder protection funds. Finally, in the event an insurance entity falters or fails, the regulations of the OECD countries stipulate rehabilitation or sanction procedures at a variety of levels, specifying the potential means of redress available to policyholders, as well as any liability of the officers and directors of the entity in question.
2. In order to take account of these different types of ownership, they are referred to as "insurer" or "insurance entity" in this document, including the guidelines.
3. Mutual insurers may actually take two different legal forms: a mutual or a cooperative. A cooperative is a capital stock entity whose shares must be held by its employees or customers (policyholders in this case). The main difference of a stock company is that the shares of a cooperative cannot be negotiated and therefore the entity cannot be quoted. On the other hand, a mutual is an entity without capital, hence without shares or shareholders. A mutual has no owner as such but is managed collectively by its policyholders. Mutuals cannot thus be redeemed or quoted. In the rest of the document, the wording "mutual insurer" will be generally used to reflect the situation of both legal status, mutuals and cooperatives, although some adaptations are specified when relevant.
4. Actually, in spite of a trend towards demutualisation in the 1980's and 1990's and the formation of mutual holding companies, the insurance market is still the part of the financial sector with the largest presence of mutual insurers. Some classes of business are handled almost exclusively by this type of organisation, which seems best suited to cover certain specific risks. This is the case with ship insurance in the United Kingdom, 90 per cent of which is written by mutual insurers. The market share of mutual insurers in the global insurance market was 25 per cent in 2001, with a more important proportion for non-life insurance (31 per cent) than for life insurance (20 per cent).
5. It may be noted that the insurer is also in a situation of information asymmetry *vis-à-vis* the potential policyholder, not knowing the latter's degree of risk aversion, real exposure to risk or behaviour in the event of becoming insured. From this want of informa-

tion stem the well-known problems of adverse selection and moral hazard – problems which insurers endeavour to alleviate through experience, better differentiation of policies in order to profile applicants, deductibles and co-insurance arrangements.

6. Apart, *inter alia*, from medical indemnity and public liability which are considered long-tail business.
7. In this perspective, the work undertaken by the OECD and the IAIS in order to enforce a more global approach and oversight on reinsurers may be stressed. The IAIS approved in 2002 principles on minimum requirements for supervision on reinsurers and has endorsed a standard on supervision of reinsurers in 2003 that mentions that the corporate governance of reinsurers should be at least of the same quality as the direct insurers. The OECD has established under the Council Decision on the Exchange of Information on Reinsurers, endorsed in July 2002, a specific and secured network aimed at confidentially exchanging information between OECD governments on reinsurers. This mechanism is designed to improve the transparency and accurate assessment of the soundness of reinsurance markets.
8. See in the Annotations to the Guidelines, the sixth, concerning the actuary, for further detail on the actuary role and function.
9. Even though in practice in OECD countries, both approaches often turn out to be not that different in their application.

Résumé : Lignes directrices sur la gouvernance des assureurs

Le 28 avril 2005, le Conseil de l'OCDE a approuvé les Lignes directrices sur la gouvernance des assureurs. Ces lignes directrices ont d'abord été adoptées par le Comité des assurances et des pensions privées dans le cadre d'une collaboration et d'intenses consultations avec des spécialistes gouvernementaux des 30 pays membres et des représentants du secteur de l'assurance et de la réassurance. Ces lignes directrices sont réputées entièrement compatibles et cohérentes avec les Principes révisés de gouvernement d'entreprise de l'OCDE établis par son Groupe de direction en octobre 2004.

Les scandales récents qui ont mis au jour d'énormes irrégularités financières et mis en relief la nécessité pour le secteur de l'assurance et ses autorités de contrôle d'améliorer les normes de gouvernance des sociétés d'assurance afin de renforcer la confiance des investisseurs et des clients dans le secteur. Les 12 points des Lignes directrices sur la gouvernance des assureurs définissent une feuille de route à cet effet pour les pouvoirs publics et devraient ainsi apporter une meilleure protection aux titulaires de police et aux actionnaires. Les Lignes directrices formulent des propositions spécifiques concernant :

- La structure et les responsabilités du conseil d'administration, ses objectifs premiers devant être la protection des actionnaires et des titulaires de polices ;
- L'intégrité et la responsabilité des administrateurs, qui doivent être juridiquement responsables de leurs actions et décisions ;
- Des systèmes rigoureux de contrôle interne et de communication financière qui prennent en compte les spécificités et les complexités de l'assurance ;
- La désignation d'un vérificateur externe indépendant chargé de certifier au moins une fois par an les comptes de l'assureur et habilité à alerter les autorités de tutelle sur des irrégularités ou sur des infractions pénales. Les Lignes directrices confirment également le rôle essentiel de l'actuaire vis-à-vis de la gouvernance des assureurs ;
- La diffusion en temps utile d'informations claires aux parties prenantes (comme les titulaires de police, les actionnaires, les autorités de tutelle et

- de contrôle) sur la situation financière de l'assureur et son exposition aux risques financiers et techniques ;
- L'accès à des voies de recours rapide auprès des tribunaux ou des autorités de réglementation ou la mise en place d'autres modalités comme les procédures internes de règlement des différends et la désignation d'arbitres indépendants.

Global Pension Statistics Indicators

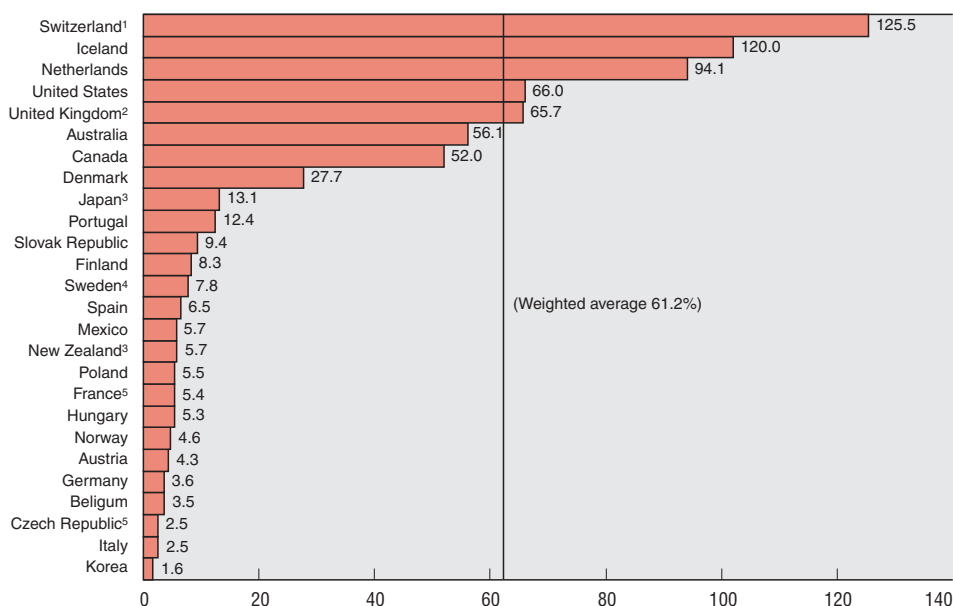
In 2002, the OECD launched, through the Working Party on Private Pensions and the Task Force on Pension Statistics,¹ the Global Pension Statistics Project,² which aims to establish a harmonised set of statistics and indicators related to funded pensions. This article³ is an extract from the OECD newsletter “Pension Markets in Focus”, Issue 1. For a full version of the newsletter, the reader can refer to the OECD website at www.oecd.org/daf/pensions/.

I. Pension funds are experiencing different rates of growth around the world

Although, in most countries, pension funds are the most important financing vehicle of funded pension plans,⁴ the economic size of pension funds varies significantly across countries. In most countries, total investments amount to less than 10 per cent of GDP. As a percentage of GDP, Switzerland and Iceland top the table in 2003 with the highest accumulation of pension fund assets (125.5 and 102.0 per cent, see Figure 1), followed by the Netherlands (94.1 per cent of GDP), the United States and the United Kingdom (respectively, 66.0 per cent and 65.7 per cent). Pension fund assets even exceed GDP in Switzerland and Iceland. Denmark, where pension funds amount to almost half of the market capitalisation of domestic shares listed on stock exchanges, is in an intermediate position with 27.7 per cent of GDP.

In 2003, total investment of pension funds increased by almost 20 per cent in OECD countries. Accordingly, the average ratio of total investment to GDP increased to 61.2 per cent. Most countries experienced a substantial increase in the ratio of pension fund assets to GDP between 2002 and 2003, the main exceptions being Belgium and the Slovak Republic where this ratio fell (see Table 1). Those countries that have started from a relatively small base like Spain, Norway, Hungary, Czech Republic and Italy are experiencing the fastest growth in pension fund assets. Pension funds in these countries had an average growth rate ranging from 24 per cent to 58 per cent over the period 2001-2003 (see Table 1). On the other hand, countries with more mature pension systems, like the United States, United Kingdom, the Netherlands and Canada have seen a less rapid, but still positive evolution, with growth rates ranging from 4 per cent to 15 per cent. In

Figure 1. **Pension fund assets in OECD countries, 2003**
in per cent of GDP



Source: OECD, Global Pension Statistics.

between are countries like Denmark, Austria, Portugal and Germany that have exhibited an average growth rate between 16 per cent and 20 per cent. In most other countries, investment growth rates amounted to less than 10 per cent.

Outside the OECD area, the pension fund systems in Chile, Malaysia and Singapore are noteworthy as they have all accumulated pension fund assets at around or above 60 per cent of GDP, comparable to the best performers in the OECD area.

The growth rate of pension fund assets is expected to accelerate further over the coming decade as both the public and private sectors intensify efforts to prepare themselves for the rapid ageing of the population. It is also expected that pension reform efforts will raise awareness regarding the implications of increasing life expectancy and promote more savings. While part of the adjustment to ageing will and, in the OECD's view, should come through later retirement, higher savings is expected to help diversify risks, especially in countries that have traditionally relied largely on "Pay As You Go" ("PAYG") systems for retirement income provision. Some OECD countries have even gone as far as replacing part (*e.g.* Hungary, Poland) or most (*e.g.* Mexico) of the "insurance" or income replacement part⁵ of their social security system by funded pension arrangements.

Table 1. Size of pension funds in the world economies, 2001-2003

	Total Investment (millions of US Dollars)			Total Investment (millions of Euros)			Share of GDP ^{9 10} (per cent)		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
OECD Countries									
Australia	212 860	239 290	295 670	237 685	253 903	263 146	57.7	58.1	56.1
Austria	7 555	8 099	10 869	8 436	8 594	9 673	4.0	3.9	4.3
Belgium	12 639	12 428	10 756	14 113	13 187	9 573	5.6	5.1	3.5
Canada	375 565	346 341	445 761	419 365	367 491	396 727	53.3	47.8	52.0
Czech Republic ¹	1 503	2 294	2 294	1 678	2 434	2 042	2.6	3.3	2.5
Denmark	43 639	44 324	58 717	48 729	47 030	52 258	27.4	25.7	27.7
Finland	9 991	10 606	13 406	11 157	11 254	11 866	8.2	8.1	8.3
France ¹	51 388	95 395	95 395	57 381	101 220	84 902	3.9	6.6	5.4
Germany	62 621	75 466	85 335	69 924	80 074	75 948	3.4	3.8	3.6
Greece	—	—	—	—	—	—	—	—	—
Hungary	2 071	2 976	4 397	2 313	3 158	3 913	4.0	4.5	5.3
Iceland	6 636	7 481	10 781	7 410	7 937	9 595	87.3	88.0	102.0
Ireland	..	..	..	..	..	..	..	..	..
Italy	19 582	21 751	36 787	21 865	23 079	32 741	1.8	1.8	2.5
Japan ²	566 881	561 437	561 437	632 994	595 722	499 679	13.6	14.1	13.1
Korea	..	8 438	9 884	..	8 954	8 797	..	1.5	1.6
Luxembourg	..	..	..	..	..	..	..	..	..
Mexico	27 204	31 456	35 743	30 377	33 377	31 811	4.4	4.9	5.7
Netherlands	411 460	374 875	545 239	459 446	397 767	482 623	107.2	89.6	94.1
New Zealand ²	4 382	4 549	4 549	4 893	4 827	4 049	8.4	7.6	5.7
Norway	6 831	7 652	10 227	7 627	8 119	9 102	4.0	4.0	4.6
Poland	4 622	7 588	11 487	5 161	8 052	10 223	2.6	4.2	5.5
Portugal	13 278	14 657	18 243	14 826	15 552	16 236	12.1	12.0	12.4
Slovak Republic	2 244	4 037	3 077	2 505	4 284	2 723	10.7	16.7	9.4
Spain	35 072	39 061	54 778	39 162	41 447	48 487	6.0	6.0	6.5
Sweden ³	18 254	18 542	23 457	20 383	19 675	20 877	8.3	7.7	7.8
Switzerland ⁴	269 010	335 605	..	300 383	356 099	..	109.4	125.5	..
Turkey	..	..	..	..	..	..	..	..	..
United Kingdom ⁵	1 040 472	1 040 472	1 179 718	1 161 817	1 104 010	1 049 949	72.7	66.5	65.7
United States	6 723 627	6 027 275	7 227 959	7 507 770	6 395 341	6 432 884	66.9	57.8	66.0
Total OECD	9 929 386	9 342 095	10 755 967	11 087 401	9 912 586	9 572 810	64.7	57.3	61.2

Table 1. **Size of pension funds in the world economies, 2001-2003** (*cont.*)

	Total Investment (millions of US Dollars)			Total Investment (millions of Euros)			Share of GDP ^{9, 10} (per cent)		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Selected non-OECD countries⁶									
Argentina	..	11 650	16 139	..	12 361	14 364	..	11.3	13.5
Bolivia	..	1 144	1 493	..	1 214	1 329	..	15.5	20.9
Brazil	..	47 317	64 444	..	50 207	57 355	..	9.3	13.1
Bulgaria	83	174	458	93	185	408	0.5	1.0	2.3
Chile	..	35 515	49 690	..	37 684	44 224	..	55.8	64.5
China	..	..	..	..	..	..	..	..	..
Colombia	4 942	6 260	7 069	5 519	6 642	6 291	0.1	0.1	0.1
Costa Rica	..	138	305	..	146	271	..	0.9	1.8
El Salvador	..	1 061	1 572	..	1 126	1 399	..	7.4	11.0
Estonia	124	909	81	139	965	72	2.0	14.7	..
Fiji	..	..	1 561	..	..	1 389	..	..	69.3
Hong Kong, China ¹	24 495	27 524	27 524	27 352	29 205	24 497	15.0	17.0	17.6
India	..	..	1 315	..	..	1 170	..	..	0.2
Indonesia ¹	3 219	4 437	4 437	3 594	4 708	3 949	2.3	2.6	2.1
Israel	..	..	..	..	..	..	..	..	..
Kazakhstan	1 210	1 727	2 631	1 351	1 833	2 342	5.6	7.1	8.8
Malaysia	..	..	58 476	..	..	52 044	..	..	56.7
Pakistan	..	..	1 143	..	..	1 017	..	..	1.7
Panama	..	..	464	..	..	413	..	..	3.6
Peru	..	4 484	6 311	..	4 758	5 617	..	8.1	10.6
Philippines	..	..	3 077	..	..	2 739	..	..	3.8
Russia	..	..	2 737	..	..	2 436	..	..	0.6
Singapore ¹	..	56 497	56 497	..	59 947	50 282	..	64.0	61.9
Slovenia	20	83	59	22	88	53	0.1	0.4	0.2
South Africa	..	..	50 328	..	..	44 792	..	..	30.4
Sri Lanka	2 698	..	..	3 013	..	..	14.6	..	..
Thailand ¹	8 676	10 176	10 176	9 688	10 798	9 057	7.5	8.0	7.1
Ukraine	..	..	5	..	..	4	..	..	0.0
Uruguay	..	893	1 232	..	948	1 096	..	9.3	11.4

Table 1. **Size of pension funds in the world economies, 2001-2003** (*cont.*)

	Total Investment (millions of US Dollars)			Total Investment (millions of Euros)			Share of GDP ^{9 10} (per cent)		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Regional Indicators⁷									
Total G10⁸	9 551 499	8 909 586	10 211 845	10 665 442	9 453 665	9 085 902	40.6	38.8	31.4
Euro area	623 585	652 338	870 809	696 311	692 174	772 050	16.9	15.2	15.6
Latin America	32 147	139 918	184 462	35 896	148 462	164 171	2.2	12.3	14.2
Total world	9 974 854	9 552 086	11 125 192	11 138 171	10 135 400	9 898 436	21.6	21.1	19.7

1. 2003 is data of 2002.

2. 2003 is data of 2002; all data is for occupational pensions.

3. Including Pension foundations, "bigger friendly societies" and "small friendly societies".

4. 2001 and 2002 are data of 1999 and 2000, respectively.

5. 2002 is data of 2001.

6. Data for Brazil, Panama, Ecuador, Fiji, Honduras, India, Indonesia, Kazakhstan, Korea, Sri Lanka, Malaysia, Pakistan, Panama, Russia, and Ukraine from FIAP; Latin American data, with the exception of Mexico, from AIOS.

7. Arithmetic sums and averages; sums may not add up due to rounding.

8. Funded pension weights used to calculate OECD weighted regional averages.

9. GDP values from OECD, Main Economic Indicators; selected Non-OECD country values from IMF, International Financial Statistics, 2005.

10. Exchange rate used: 1.116625 in 2001; 1.061066667 in 2002 and 0.89 in 2003 from OECD, Main Economic Indicators.

Conventional sign: ". . .": not available and "-" close to zero.

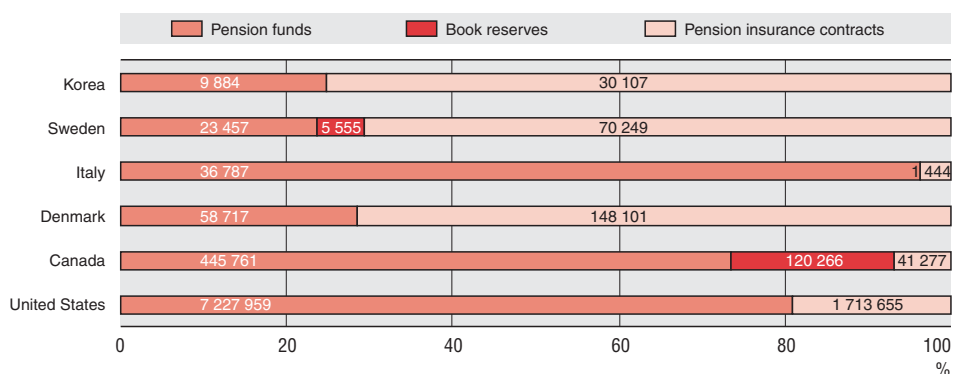
Source: OECD, Global Pension Statistics.

II. Other funded pension arrangements are rapidly developing in some OECD countries

In addition to pension funds, in some countries funded pension arrangements include pension insurance contracts and pension plans managed by other financial institutions such as banks or investment companies. Information on these other arrangements, however, is not readily available, especially for products sold in the retail market (personal pension plans). Information on the specific size of the proportion of life insurance investments that correspond to pension plans is available for a few OECD countries (see Figure 2). Following the OECD classification, these plans are referred to as pension insurance contracts (for definitions see Table 4).

A rough estimate of the size of the overall funded pensions market in other OECD countries is provided by looking at the combination of pension fund and life insurance investments (see Table 2) as pension and long-term investment saving products are a substantial part of the life insurance market. It can be seen that in some countries like France the relatively small pension fund sector is compensated by a highly developed life insurance industry, leading to a combined asset to GDP ratio that is similar to that of other OECD countries like Canada and Japan with much larger pension fund systems.

Figure 2. **Private pension plans' assets by type of financing vehicle, 2003**
In millions of USD and as a share of total



Source: OECD, Global Pension Statistics.

Table 2. **Pension funds and life-insurance assets in OECD economies**

	Total assets for funded pension plans + life insurance investments ⁶	
	Millions of US dollars	Share of GDP ⁷
OECD Countries		
Australia	337 385	82
Austria	45 973	23
Belgium	89 978	37
Canada	501 153	69
Czech Republic ¹	5 432	8
Denmark	163 950	95
Finland	33 119	25
France ¹	813 085	57
Germany	..	..
Greece	..	..
Hungary	5 968	9
Iceland	7 512	89
Ireland	..	..
Italy	258 071	22
Japan ²	1 949 909	49
Korea	124 213	26
Luxembourg	..	..
Mexico	..	..
Netherlands	539 343	129
New Zealand ²	..	..
Norway	58 271	31
Poland	14 895	8
Portugal	27 106	22
Slovak Republic	4 904	20
Spain	..	..
Sweden ³	..	..
Switzerland ⁴	497 241	186
Turkey	..	..
United Kingdom ⁵	2 004 478	128
United States	8 450 761	81
Total	15 932 747	88

1. 2003 is data of 2002.

2. 2003 is data of 2002; all data is for occupational pensions.

3. Including pension foundations, "bigger friendly societies" and "small friendly societies".

4. 2001 and 2002 are data of 1999 and 2000 respectively.

5. 2002 is data of 2001.

6. Life insurance data from OECD Insurance Statistics database.

7. GDP values from OECD, Main Economic Indicators.

Source: OECD, Global Pension Statistics and Insurance Statistics database.

III. Funding initiatives within PAYG systems are intensifying

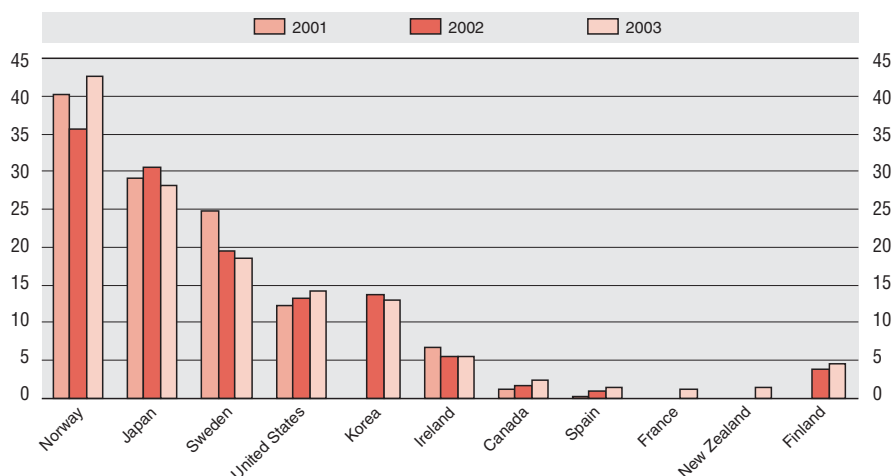
Funding is also growing in what have traditionally been exclusively PAYG-financed, social security systems. Funding in these systems takes the form of reserve funds, which in most cases are institutions with their own governing board and resemble pension funds in many aspects. Reserve funds have been growing

at a rapid pace in a few OECD countries as a result of transfers of privatisation proceeds (see Figure 3). In Norway, the petroleum fund is not formally a social security reserve fund, but its investments are likely to be used to meet the liabilities of the Norwegian public pension system. In Finland, social security assets include also the statutory pension funds (58.3 per cent of GDP), while in Sweden they include the assets of the premium pension system (PPM) (3.0 per cent of GDP), but those are not shown in Figure 3 and 4.

The asset allocation of reserve funds varies significantly across countries (see Figure 4). At one extreme is the Canadian Pension Plan (CPP), which invests nearly all its assets in equities. At the other extreme, the US social security trust fund has a portfolio consisting exclusively of US government securities. In between are countries like Norway, Finland, New Zealand and Sweden where the reserve funds invest between 30 per cent and 60 per cent of their portfolio in equities.

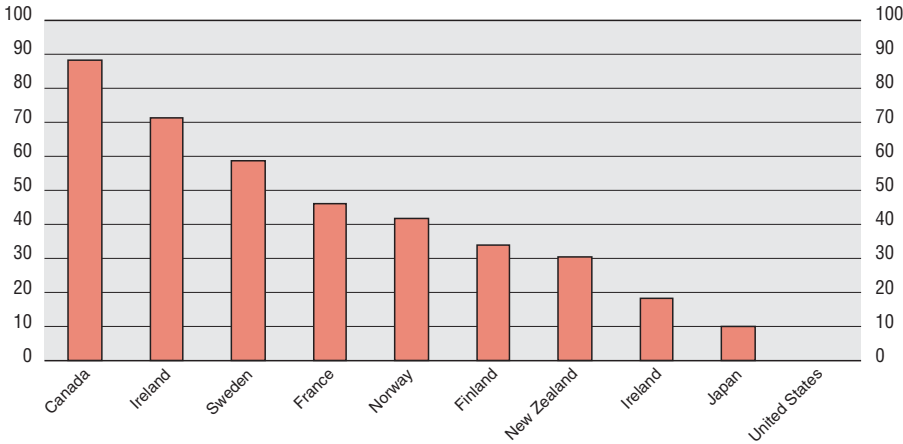
In some OECD countries, such as Japan, Sweden, Norway, reserve funds actually manage more assets than the combined total assets of pension funds and life insurance companies (see Figure 5). Unlike pension funds, however, the future evolution of reserve funds is subject to some uncertainty. In some countries, the recent build-up of assets is expected to be used primarily for meeting the cost of the baby-boom in the coming years. However, as some degree of funding seems advisable for social security systems, further government effort to promote the continuation of reserve funds may be expected.

Figure 3. **Social security reserves for selected OECD countries, 2001-2003**
in per cent of GDP



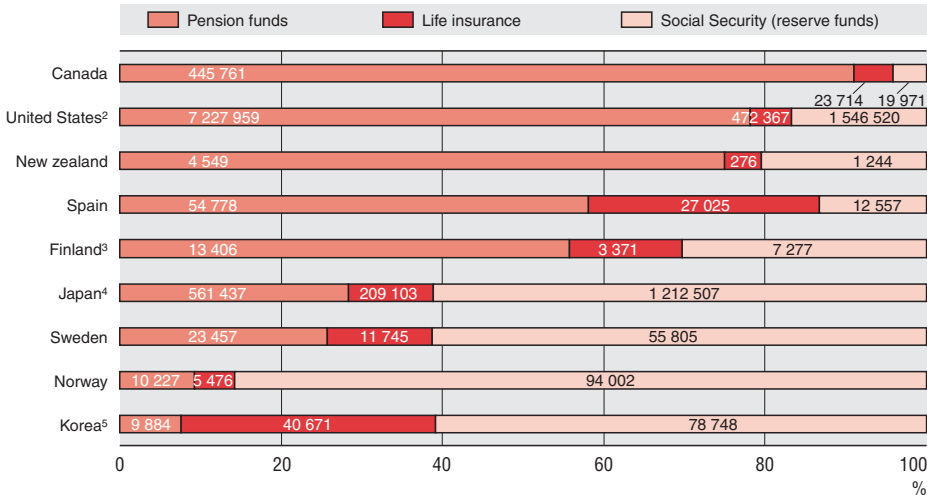
Source: OECD calculations and national sources.

Figure 4. **Social security reserve fund equity investment, 2003**
in per cent of total assets



Source: OECD calculations, and national sources.

Figure 5. **Contractual savings in selected OECD countries, 2003¹**



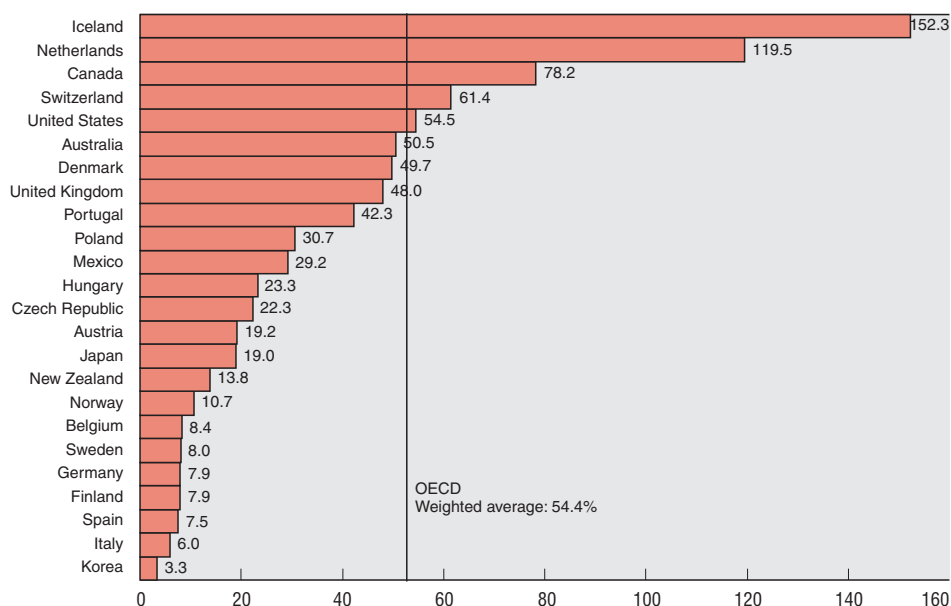
Source: OECD, Global Pension Statistics.

IV. Pension funds: a powerful actor in financial markets

Five countries (United States, United Kingdom, Canada, Netherlands, Switzerland) continue to dominate the pension fund market, with a combined market share of more than 90 per cent of the total for the OECD. OECD pension funds assets rose from 29 per cent of GDP in 1987 to 61 per cent in 2003 (USD 10 756 bn). OECD pension funds assets represent an aggregate of 54.4 per cent of OECD domestic listed shares' market capitalisation (see Figure 6). The ratio of pension fund assets to market capitalisation is highest in Iceland and the Netherlands (respectively, 152 per cent and 120 per cent), followed by Canada (78 per cent), Switzerland (61 per cent), the United States (55 per cent) and Australia (51 per cent).

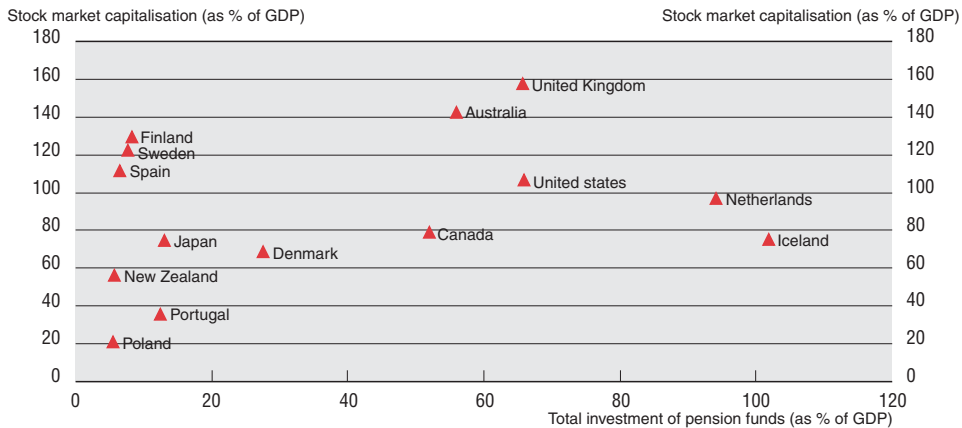
Several countries showing high ratios of total pension funds investment to GDP tend also to exhibit high ratios of market capitalisation to GDP, as evidenced in Figure 7. While large pension funds and developed capital markets are to some extent both a result of a market oriented financial system, the preference for shares amongst pension funds in some OECD countries like the Netherlands, the United Kingdom and the United States has certainly contributed to the growth of the stock market in these countries. However, countries in which big listed companies have developed an international shareholder basis, such as Sweden and Finland, have also witnessed strong growth in their local stock exchanges.

Figure 6. Pension fund assets in per cent of stock market capitalisation, 2003



Source: OECD, Global Pension Statistics.

Figure 7. **Weight of total investment as compared to the size of stock markets in selected economies, 2003**



Source: OECD, Global Pension Statistics.

V. Pension fund portfolios are becoming increasingly diversified, but wide disparities between countries remain

About one third of OECD countries with pension funds place limits on pension funds' holdings by asset type.⁶ The most common are limits in equities and foreign securities. Equity limits are applied by eighteen of the 30 OECD countries with pension funds. These limits range from 70 per cent in Denmark and Greece to 0 per cent in Mexico.

After 2000, the trend toward equities has been reversed. The decreasing proportion of assets held in equities has resulted from both the poor overall performance of stock markets as well as the consequent outflow from equities towards alternative investments (such as private equity and hedge funds, included under other investments).

Between 2002 and 2003, the average allocation to fixed income securities (the largest asset class) decreased to 46.9 per cent at end-2003 compared to 49.5 per cent one year earlier. For the OECD as a whole, the second largest asset class of assets held by pension funds consists of shares (21.1 per cent), followed by mutual funds (11.2 per cent).

The breakdown of assets according to the type of investment product varies widely across countries (see Table 3):

Table 3. **Structure of assets of pension funds, 2003**

	Cash and deposits	Bills and bonds issued by public administration	Corporate bonds	Loans	Shares	Land and buildings	Mutual funds (CIS)	Unallocated insurance contracts	Other investments
OECD Countries									
Austria	2.3	73.6	0.0	0.7	16.5	0.7	..	..	6.1
Belgium ¹	4.4	13.6	3.2	0.3	14.6	1.1	55.8	2.6	4.1
Canada	4.9	18.7	5.4	..	23.6	3.5	36.7	..	7.2
Czech Republic	7.9	60.1	24.8	0.0	4.9	0.4	0.0	..	1.9
Denmark	0.3	25.6	39.9	0.5	21.1	2.7	7.8	..	1.7
Finland	0.0	0.0	33.3	0.2	27.0	15.4	0.0	0.0	22.6
France	..	..	..	..	..	..	..	..	..
Germany	2.6	36.3	0.0	27.0	12.7	6.2	7.8	..	7.4
Hungary ¹	4.4	68.1	5.2	0.0	8.7	0.0	5.8	0.0	7.8
Iceland	2.5	35.4	14.9	12.8	30.4	0.2	..	..	2.0
Italy ¹	9.1	33.0	0.5	0.0	5.8	11.0	4.3	20.4	15.9
Korea	4.4	34.6	30.6	13.3	2.3	1.8	4.0	..	6.1
Mexico ¹	0.2	85.4	14.4	0.0	0.0	0.0	0.0	0.0	0.0
Netherlands	2.2	25.5	13.8	5.3	44.6	5.0	..	..	3.5
Norway	4.6	28.8	33.8	3.9	19.2	5.8	..	..	3.9
Poland	4.8	61.0	1.7	0.0	32.1	..	0.0	..	0.4
Portugal	9.0	21.4	21.6	0.0	19.3	8.8	16.5	0.0	3.4
Spain	4.2	20.0	35.0	0.0	15.9	0.3	6.7	..	17.9
Switzerland ²	9.9	29.3	..	5.0	19.1	12.3	17.5	..	4.4
United Kingdom ¹	2.6	14.5	4.7	0.5	53.8	4.3	11.4	6.2	2.0
United States	7.1	4.9	4.8	0.2	29.3	0.8	21.3	8.7	22.9
Selected non-OECD countries									
Brazil ¹	44.2	14.9	2.2	3.9	15.9	6.7	11.6	0.0	0.6
Bulgaria	19.9	62.5	11.5	..	2.8	1.8	..	..	1.5
Estonia	8.2	32.6	23.3	0.0	33.5	0.0	1.8	4.8	0.6
Slovenia ¹	21.9	54.7	19.5	0.0	2.5	0.0	1.4	0.0	0.0
Indonesia ¹	70.9	0.1	11.9	0.7	4.1	6.0	1.3	0.0	6.9
Kazakhstan ¹	9.7	48.8	33.7	..	5.0	..	..	..	..
Singapore ¹	2.7	96.4	0.0	0.0	0.0	0.2	0.0	0.0	0.7

1. 2001 Data. 2. 2000 Data. 3. Conventional sign: “..”: not available. Total may not add up due to rounding or to negligible value.

Source: OECD, Global Pension Statistics.

Table 4. **OECD classification of pension plans by financing vehicles**

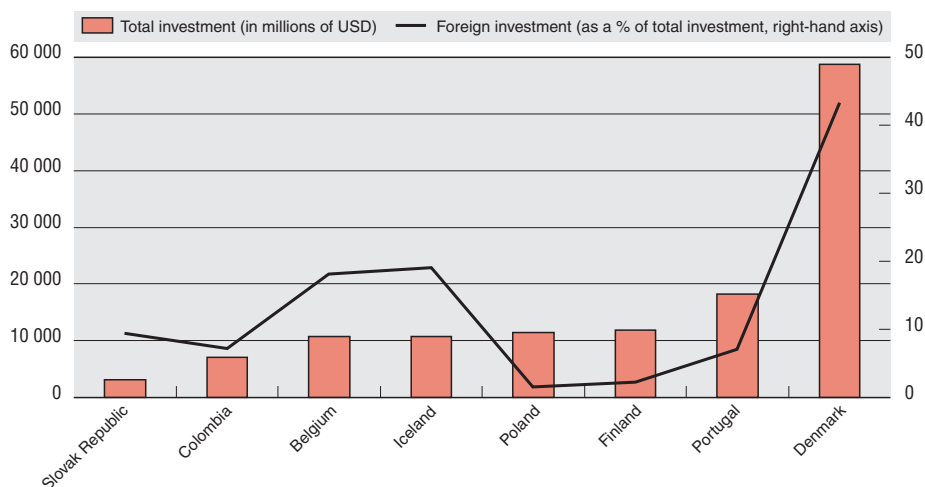
Financing Types

Pension funds (autonomous)	The pool of assets forming an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. The plan/fund members have a legal or beneficial right or some other contractual claim against the assets of the pension fund. Pension funds take the form of either a special purpose entity with legal personality (such as a trust, foundation, or corporate entity) or a legally separated fund without legal personality managed by a dedicated provider (pension fund management company) or other financial institution on behalf of the plan/fund members.
Book reserves (non-autonomous)	Book reserves are sums entered in the balance sheet of the plan sponsor as reserves or provisions for pension benefits. Some assets may be held in separate accounts for the purpose of financing benefits, but are not legally or contractually pension plan assets.
Pension insurance contracts	An insurance contract that specifies pension plan contributions to an insurance undertaking in exchange for which the pension plan benefits will be paid when the members reach a specified retirement age or on earlier exit of members from the plan.
Other	Other type of financing vehicle not included in the above categories.

Source: OECD, "Private Pensions: OECD Classification and Glossary".

- In the majority of countries, bills and bonds (public and corporate) rank first in asset allocation. In Austria, the Czech Republic, Denmark, Hungary, Iceland, Korea, Mexico, Norway, Poland, Spain, Bulgaria, Estonia, Kazakhstan, Singapore and Slovenia, it accounts for over one half of total investments.
- In two countries, equity shares account for 44 per cent or more of assets: the Netherlands and the United Kingdom (where they account for 53.8 per cent despite the stock market's downturn).
- In Belgium and Canada, mutual fund shares are predominant in the asset structure.

In most countries, cash and deposits, loans, and real estate (lands and buildings) only account for relatively small amounts. Real estate, however is a significant component of pension fund portfolios in Finland, Italy and Switzerland (over 10 per cent of total assets). Similarly, cash and deposits is a major component for Brazil and Indonesia (respectively accounting for 44.2 and 70.9 per cent of total assets).

Figure 8. **Relative and absolute size of foreign currency investment of pension funds, 2003**

Source: OECD, Global Pension Statistics.

VI. Pension funds have also increased their diversification in foreign markets in recent years

Euro area-based pension funds have benefited from the elimination of currency risk, but even in other countries that have their own currency a move towards greater international diversification of pension fund portfolios has been observed, especially in those countries where pension funds are oversized in relation to the domestic capital market. Questions remain, however, as to the extent of home bias in investment strategies. Investment limits and currency matching requirements also account for the relatively low investment abroad in some countries, though, in a few cases, these rules are being relaxed. For example, Canada eliminated the 30 per cent cap in February 2005.

While specific information on investment by issuing location is not available, the data on investment by currency paints a largely positive picture of the extent of diversification in some OECD countries like Denmark (see Figure 8). On the other hand, a number of OECD countries invest with their own currency (*e.g.* Poland and Slovak Republic) invest relatively little in foreign currency denominated securities (less than 10 per cent of total assets).

VII. The original data sources are official sources

Within the framework of pension regulation and supervision, pension funds are required to submit comprehensive sets of published and non-published data to pension authorities. In some countries, pension authorities also collect information on other funded pension arrangements, such as pension insurance contracts and personal plans administered by banks or investment companies. In several Member countries the relevant pension authority also assumes the statistical functions of compiling aggregated data on pension funds and analyses the national pension market. In some other countries this role is taken on by the national statistical offices (see Table 5) or by relevant ministries.

The coverage of the statistics follows the regulatory and supervisory framework. All authorised pension funds are therefore normally covered by the Global Pension Statistics exercise. The main exceptions are pension funds established or treated as social security institutions by a country's legislation. This is the case of the statutory pension funds in Finland and the Premium Pension System in Sweden. The information collected relates primarily to pension funds for both private and public sector employees. For Japan and the United States, detailed data on public sector pension funds is not currently available.

VIII. Additional notes to be taken into consideration when interpreting the data

Common note to Tables 1, 2, 3 and Figure 1

Data include pension funds according to the OECD taxonomy that are subject to private pension regulation. All types of plans are included (occupational and personal, mandatory and voluntary). Pension funds include also some personal pension arrangement like the Individual Retirement Accounts (IRA) in the United States. Assets pertaining to the 1st pillar social security system are excluded as well as public pension funds that are subject to public pension regulation, like funds for government workers [e.g. United States and Japan, accounting respectively, for USD 1,967 billion (18.0 per cent of GDP), and USD 406.7 billion (9.5 per cent of GDP)] and book reserves within sponsoring companies. For Japan, data do not include the funded public pension plans. For Sweden, data do not include the Premium Pension System. For the United States, data do not include the state and local government employee retirement funds.

Table 5. **List of official sources**
Statistical sources for OECD Global Pensions Statistics by country

OECD countries

Austria	FMA Financial Market Authority
Belgium	Commission Bancaire, Financière et des Assurances
Canada	Statistics Canada
Czech Republic	Ministry of Finance
Denmark	Danish Financial Supervisory Authority
Finland	Insurance Supervision Authority
Germany	Federal Financial Supervisory Authority
Hungary	Hungarian Financial Supervisory Authority
Iceland	Financial Supervisory Authority
Italy	Commissione vigilanza fondi pensione (COVIP)
Japan	Ministry of Foreign Affairs
Korea	Korea Life Insurance Association
Mexico	CONSAR
Netherlands	Statistics Netherlands
Norway	Kredittilsynet
Poland	Insurance and Pension Funds Supervisory Commission of Poland
Portugal	Instituto de Seguros de Portugal
Spain	Banco de España
Spain	Ministry of Economy
Slovak Republic	Ministry of Finance of the Slovak Republic
Switzerland	Office fédéral de la statistique
Sweden	Finansinspektionen (the Swedish Financial Supervisory Authority)
United Kingdom	National Statistical Office (ONS)
United States	Department of Treasury
United States	Federal Reserve
United States	Department of Labor

Non-OECD countries

Argentina	AIOS
Bolivia	AIOS
Brazil	Ministry of Finance – SUSEP
Brazil	Ministry of Social Security
Bulgaria	Financial Supervision Commission
Chile	AIOS
Columbia	AIOS
Costa Rica	AIOS
El Salvador	AIOS
Estonia	Financial Supervision Authority
Hong Kong	Mandatory Provident Fund Schemes Authority
Indonesia	Ministry of Finance of the Republic of Indonesia
Kazakhstan	Financial Supervision Agency of Kazakhstan
Peru	AIOS
Singapore	Monetary Authority of Singapore
Slovenia	Slovene Insurance Supervision Agency
Slovenia	Slovene Security Market Agency
Thailand	Securities and Exchange Commission
Uruguay	AIOS

Specific notes

Figures 3 and 4:

Sweden: only API/France: 2004 data/Korea: recording period, 31 June 2003/
Japan: recording period, 31 March.

In the chart, for France, Finland and Korea, data point at “zero” means data is not available. For New-Zealand it is not applicable.

Figure 5. *Contractual Savings, Selected OECD countries, 2003:*

1. 2002 Data used for life insurance data for all countries.
2. The Social Security trust funds, managed by the Department of the Treasury, are Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds. All securities held by the trust funds have been issued by the Federal Government.
3. Includes State pension fund (statutory pension funds and government workers' pension funds are excluded).
4. Public pension funds include Employees' Pension fund and National Pension fund.
5. Social security funds are composed of National Health Insurance Corporation, Health Insurance Review Agency, Industrial Accident Compensation Insurance and Prevention Fund, National Pension Fund, The Special Accounting for N.P.F. (National Pension Fund), Patriots and Veterans Affairs Fund, Employment Insurance Fund, Wage Claim Guarantee Fund, Fund for Employment Promotion and Vocational Rehabilitation of the Disabled.

IX. Contact information

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Notes

1. These bodies are subsidiary bodies of the Insurance and Private Pensions Committee.
2. This project is currently financially supported by voluntary contributions both from the public and private sectors, namely ABI (American Benefits Institute), Allianz Global Investors, COVIP, the European Bond Commission, ING Group, Pioneer Investments and the Portuguese Pension Supervisory Authority.
3. See also *Financial Market Trends* No. 87 and 88.
4. Pension plans are defined by the OECD as arrangements or contracts that have a retirement income purpose. See the OECD (2004), *Private Pensions Classification and Glossary*.
5. This part complements the other main objectives of social security arrangements, namely poverty prevention or “redistribution”.
6. Other than self-investment limits (*i.e.* investment in the sponsoring company).

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