

# **PENSION FUND GOVERNANCE, INVESTMENT STRATEGIES, AND THEIR ROLE IN CORPORATE GOVERNANCE**

**(Note by the OECD Secretariat)**

## **Background**

1. This note follows up on the project proposal presented at the last meeting of the Working Party in December (DAFFE/AS/WD(99)20). It considers the general issues raised by both the governance of pension funds and their role in the corporate governance of the companies that they invest in. The note also expands on some of the issues highlighted in DAFFE/AS/PEN/WD(99)17, regarding administrative costs in defined contribution plans.
2. The country information provided is based mainly on a retirement income study covering nine member countries: Canada, Finland, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, and United States. For the sake of comparison, the experience of some other member countries (e.g. Australia, Hungary, the Czech Republic) and that of some non-Member countries (especially in Latin America) is also provided.
3. In accordance with the programme of work of the Working Party (DAFFE/AS/PEN/(2000)2), this note also suggests a research study that will be started in 2000 and will be developed over the period 2001-2.

## **The relevance of pension fund governance**

4. Pension funds are playing an increasingly important role as both channels for retirement savings and as intermediaries in financial markets. This combined role makes them a prime concern of governments and regulators from a variety of perspectives.
5. Pension funds, however, are by their nature subject to potential conflicts of interest arising between the fund administrators and the ultimate beneficiaries of the fund. Pension funds, therefore, require a set of internal statutes and external regulations to ensure that they are managed in the best interest of beneficiaries. The balance between internal statutes and external regulations is a delicate one, and depends largely on a country's social and legal structure.
6. Pension fund governance has direct implications for retirement income, both in terms of its impact on administrative efficiency and on the investment strategies of the pension fund, since these two factors together determine the performance of pension funds. In addition, pension fund governance affects the extent to which these institutional investors engage in shareholder activism, participating in the governance of the companies that they invest in.

## **Types of pension funds and their legal and governance structures**

7. One of the critical determinants of the legal and governance structure of pension funds is related to the nature of the pension plan that they finance. As described in the taxonomy exercise developed by the Working Party (see DAFFE/AS/PEN/WD(99)15), one can distinguish between two main types of pension funds, those that support exclusively a pension plan restricted to specific participants (so-called closed funds) and those that are tied to pension plans that do not have membership restrictions (so-called open funds).

8. In general, closed funds support occupational and employer-sponsored pension plans, while open funds support pension plans operated by financial companies (banks, insurance companies, brokerage companies, and mutual funds). Closed funds, therefore, are normally set-up by employers and occupational associations, while open funds are established by financial companies. There are, however, some exceptions. In Hungary, for example, employers and employment associations can set-up open funds also.

9. Closed and open pension funds differ in legal structure in most OECD countries. While closed funds are usually established in the trust form, open funds are usually established in the corporate form. The “trust” is a concept of Anglo-Saxon law in which an identified group of assets is constituted and managed by trustees for the benefit of another party (the beneficiary). The pension plan member is the beneficiary of the trust. Closed funds in Australia, Canada, Italy, the Netherlands, the United Kingdom, and the United States, among other OECD countries, operate in the trust form. In some other countries, however, closed pension funds operate as mutual savings or insurance associations (e.g. Hungary, Germany), where the plan members are the owners of the institution operating the plan.

10. Open funds, on the other hand, operate typically in the corporate form, in which investors purchase units that entitle the holder to a proportional share of the value of the fund’s portfolio. The open fund itself is managed by a financial company, which may be a legal entity exclusively dedicated to this task or may have other business interests. Like other corporations, the financial company has a board of directors with oversight responsibility and certain rights of shareholders to obtain information and to participate in certain key decisions of the company.

11. Open funds have been recently introduced in various countries that have reformed their social security systems structurally, including many Latin American countries (where they are often mandatory), the Czech Republic and Poland. In all these countries, open funds are operated by financial companies that are exclusively dedicated to this task. Open funds were also introduced in Italy as a result of legislation from 1995. Hungarian open funds, on the other hand, are an exception: they have the same legal form as the closed funds (mutual savings associations).

12. The limit between open funds set up in the corporate form and other collective investment vehicles is often blurred. The legal nature of open pension funds is for example very similar to that of mutual funds. The difference is often marked by a separate tax or/and regulatory treatment. For example, investment in open funds can only typically be redeemed after retirement or is subject to tax penalties if the balance is cashed in, while investments in mutual funds are not usually subject to any liquidity constraints. Another difference is the requirement for specialist financial intermediaries to administer open funds as described above.

13. Closed and open funds also differ in governance structures. In the case of closed pension funds set up in the trust form, the administration of the fund is the responsibility of a board of trustees that represent the interests of the beneficiaries. The composition and responsibilities of the board vary depending on the country in question. In Italy, the Netherlands, and Japan (the Employees Pension Funds), for example, closed pension fund boards must be composed of an equal number of employee and employer representatives. The board's responsibilities are broad and include the investment management of the fund. In some places (e.g. the Canadian province of Quebec) the Board must delegate executive responsibilities to a pensions committee. Most countries also permit the board to contract out at least the fund management function to financial intermediaries. However, the pension fund board will typically specify certain parameters in an investment mandate and will subject the administrator to performance evaluations. There are also some special cases: in Italy, for example, closed funds are obliged to contract out asset management to financial institutions.

14. The administration and governance of open funds set up in the corporate form, on the other hand, is normally subject to the same rules that apply to other funds managed by financial companies. In some countries, however, special rules are applied to open funds. For example, in Italy, open pension funds must contract the provision of benefits with insurance companies.

15. Unlike in other OECD countries, the governance structure of open funds in Hungary is the same as that of the closed funds. The main decision-making body is the assembly of all the members, or the general delegate assembly of their representatives. The funds must be operated by members of a Board of Directors, who are chosen by the assembly and audited by an elected auditing committee. The Board's responsibilities are similar to those under the trust form. It must also employ certain experts, such as an executive director, actuary, accountant, and lawyer.

### **Administrative efficiency**

16. The operational expenses of managing a pension fund can have a dramatic effect on retirement income in defined contribution plans and can lead to lower benefit promises in defined benefit plans. Estimations using a forty-year contribution record and different return scenarios show that a one percent charge on assets managed per year can reduce the accumulated balance at retirement by between ten and twenty percent.

17. The legal and governance structure of a pension fund is probably the single most important determinant of its administrative efficiency. In general, while it is in the interest of beneficiaries to minimise administrative costs for a given level of fund management performance, it is not always easy to alienate the interests of administrators with those of the beneficiaries, either via internal governance structures or external regulations.

18. Some observers have claimed, for example, that closed funds are much cheaper to run than open funds because the former do not require expenses on marketing, advertising, and sales forces. Some recent academic work developed by the World Bank (James et al. (2000)) has found evidence that corroborates this hypothesis for defined contribution plans. Integrated governance structures that rely on a board of directors to manage a fund for a specific group of employees appear to provide cheaper account and fund management services to beneficiaries than those where workers sign contracts directly with financial intermediaries.

19. External regulations can also have an important impact on administrative efficiency. For example, regulations that limit the frequency of transfers between pension plans can significantly reduce administrative expenditure by pension funds.

## **Investment strategies**

20. The investment strategies of pension funds are relevant not only from the perspective of retirement income but also because of their impact on the development of capital markets and the supply of capital for innovative enterprises. Such objectives merit attention on their own right. In addition, capital market development in turn affects the range of investment products and the extent of diversification of pension fund portfolios. There is in essence a symbiotic relationship between pension fund investment and capital market development that may act to the benefit of participants in pension plans.

21. Both governance structures and external regulations play a critical role in investment strategies. The former determines the investment objectives, strategies, and tools of fund managers, while the latter can affect the asset allocation of the portfolio. There is a long controversy on the extent to which different governance structures and investment regulations affect the investment strategies of pension funds and hence their performance.

22. One of the most prominent cases of a failure of internal governance rules, combined with a lack of external regulations, is the Maxwell scandal in the UK. During the early 90s, the pension fund of the Maxwell group lent significant amounts to private companies owned by Maxwell and also held a significant portion of its portfolio invested directly in these companies. The fund managers, under the direction of Robert Maxwell, used the collateral from these loans to prop up the share price of the ailing group and further increased the fund's exposure to self-investments. As the group collapsed, a large percentage of the pension fund assets were lost.

23. Following this scandal, a self-investment limit of 5% was introduced and trustees were given the obligation to ensure such limits were adhered to. The 1995 Pensions Act also introduced fines for rule breaches by trustees, and eventual disqualification and emphasised the need for adequate governance standards and basic prudential investment management principles. In particular, it introduced a requirement for independent custodians, less leverage by the employer over the trustees (more employee trustees), and better independent actuarial information for trustees.

24. Fraudulent or imprudent practices such as those that characterised the Maxwell case also took place in the US before the introduction of ERISA in 1974. This legislation introduced explicit governance requirements on pension fund management and identified clearly both the responsibilities of trustees and the participants' right for class action.

25. On a less dramatic scale, but equally relevant from the perspective of beneficiaries, is the extent to which external quantitative restrictions on asset allocation restrict the degree of diversification of investment portfolios into riskier assets and hence hamper pension fund performance. In this respect, Davis (1995) found that pension funds in countries that apply the prudent person approach rules to investment regulation tend to perform better than those in countries where quantitative restrictions are applied.

26. From a governance perspective, the distinction between closed and open funds can be useful when analysing the investment management strategies of pension funds. A few countries (e.g. the UK, Finland, the provinces of Ontario and Quebec in Canada) require the board or committee of a closed fund to adopt a Statement of Investment Policies. In addition, closed pension funds are subject to specific investment regulations. In the Netherlands, Japan, the UK, and the US the prudent person approach is applied, while many other OECD countries apply specific quantitative restrictions. These different approaches are discussed in a document of the Insurance Committee (DAFFE/AS(2000)3).

27. An important contrast also arises between the investment management strategies of pension funds linked to defined benefit (DB) plans and those linked to defined contribution (DC) plans. In some countries, closed pension funds linked to defined benefit plans have more aggressive portfolios than those linked to defined contribution plans. This difference has been traced to the fact that plan participants bear investment risk in defined contribution plans. In the UK, for example, DB plans invest nearly 80% of their assets in equity, while DC plans invest no more than 25-30% in these financial instruments. In the US, meanwhile, while equity allocation in the overall portfolio is similar across DB and DC plans, the latter invest a large portion of their equity portfolio in company stock.

28. Open funds, especially those in new private pension systems in Eastern Europe and Latin America, also tend to be subject to specific quantitative restrictions. These include limits by asset class, limits by issuer and individual securities, as well as ownership concentration rules. These are used in all Latin American countries with mandatory private pension systems, as well as in Hungary, the Czech Republic, and Poland. In Hungary, open funds are subject to the same investment rules as closed funds.

29. A final important issue in investment strategies is the type of strategic management carried out. A difference is often made between active and passive asset management, where the latter involves the tracking of some market index and therefore tends to be less costly than active strategies. Indexation to a market benchmark may also require an active role in corporate governance, especially among the large pension funds.

### **Corporate governance activities by pension funds**

30. Internal statutes and external regulations also determine the extent to which pension funds are permitted to become active shareholders of private corporations or are restricted to play a silent role via buy and sell strategies of their positions.

31. To the extent that pension funds grow in relation to the market, an active approach to investment management and a silent role in corporate affairs become less viable. In countries like the UK or the US, for example, pension funds already hold over one third of all listed equities. In such circumstances, selling the shares of underperforming companies on a large scale may be detrimental for pension funds, because of their adverse impact on share prices. However, less liquid markets need not necessarily lead to more shareholder activism, since the gains from private information are reduced, as pension funds cannot increase their stock holdings in overperforming companies on a large scale without turning prices against them. Shareholder activism may be nonetheless fomented by the fact that pension funds' equity portfolios increasingly replicate market indices. Pension funds are thus forced to hold long term positions in certain stocks over a long period, giving them an additional interest to exert active corporate governance.

32. The role of pension funds in corporate governance has become a critical issue because of its potential to control agency problems between the managers of a company and its shareholders. It can thus have dramatic consequences for the performance of the companies that pension funds invest in, and, as a result, on the market value of the pension funds' portfolios.

33. The evidence on role of pension funds in corporate governance, however, has been so far rather muted. A recent paper by Faccio and Lasfer (2000) shows that UK occupational pension funds have not been effective at monitoring, in the sense that firms with a large ownership presence of pension funds have neither complied better with the Code of Best Practice nor outperformed their competitors. Similar conclusions have been reached about US pension funds (e.g. Wahal, 1996), but there is also a branch of research that defends the opposite conclusion, at least for some of the larger funds linked to public pension plans (e.g. Smith, 1996).

34. In both countries, however, there have been for some time calls for greater involvement by pension funds in corporate affairs. In the UK, the Cadbury Report of 1992, written in the aftermath of the Maxwell scandal, recommended that institutional investors, including pension funds, make greater use of their voting rights and seek contacts with companies at a senior executive level. It recommended that they monitor boards especially when there is a high concentration of power in the hands of the chief executive.

35. In the US, shareholder activism by pension funds took root much earlier, largely as a result of government action. In the mid-1980s the Department of Labor issued bulletins calling non-public pension funds to exercise the voting rights attached to their equity investments “on issues that may affect the value of the plans’ investment”. In 1994, the Department of Labor formalised this recommendation into a requirement, and confirmed that it applied to foreign as well as US equity holdings. Public funds, such as the California Public Employees’ Retirement System (CALPERS), while not subject to these regulations, have been active shareholders for at least a decade.

36. In other countries, such as Japan and Germany, pension funds also have a great potential to become active shareholders. Other institutional investors, such as banks, already have very close relationships with private companies and participate in critical decision-making. To the extent that these countries promote the development of pension funds it can be expected that they will play a role in corporate governance similar to that of other institutional investors.

37. Most of the factors that were discussed above in relation to investment management must also be considered when analysing the role of pension funds in corporate governance. In particular, the extent to which a plan is of a defined benefit or defined contribution nature may affect the pension fund’s investment horizon, and therefore the fund managers’ interest in active corporate governance as opposed to active portfolio management.

38. For closed funds, another important difference is between funds that are internally managed and those that are externally managed. Funds that delegate the investment function to external fund managers may be less likely to play an active role in corporate governance because they are not able to trade profitably on any private information that results from their activism.

39. One type of quantitative restrictions that has a direct impact on the extent to which pension funds can play a role in corporate governance are ownership concentration rules. In Canada, pension funds may not own more than 30% of the voting shares of one company, while in Sweden, the same limit is imposed at 5%. In Italy, the holding of shares of closed-end funds is limited to 25% of the closed-end fund’s assets. On the other hand, neither the UK nor the US subject pension funds to explicit quantitative constraints on ownership concentration.

40. Legislations also differ in the extent to which there are direct or indirect qualitative controls on the role of pension funds in corporate affairs. These include for example, rules on participation in shareholder meetings, on voting alliances between different pension funds, and on the election of boards of private corporations. Pension funds in the UK and Australia, for example, have no legal duty to vote, while those in the US do. On the other hand, UK pension funds that hold a “block of shares” are not subject to any filing requirements, while those in the US must file the 13(d) Form with the Securities Exchange Commission. US pension funds can in fact be sued for breaching any duty of disclosure to their plan participants. This applies to investors who, individually or jointly, hold 5% or more of a firm’s equity. Hence, while individual action by a pension fund is not required in the UK, UK funds face fewer disclosure obstacles to act jointly than their US counterparts when voting in the election of boards of companies.

41. Differences in corporate governance legislation across countries can also drive a wedge between the behaviour of local and foreign pension funds with respect to the monitoring of domestic companies. Some observers have in particular raised concerns that countries that promote active corporate governance by pension funds may gain a disproportionate level of influence over the direction of listed companies in a different country where these pension funds invest.

## **Study proposal**

42. The proposed study would have four main components:

- Data collection: this component should have as its main objective the collection of information regarding the internal governance structures of pension funds and the main governance requirements imposed by regulations, as well as internal rules and external regulations that affect pension fund investment strategies and their role in corporate governance. It would be developed via a questionnaire to be sent in autumn 2000. The following are some important features of the governance structure on which information should be collected:

1. the type of pension plans that the pension fund is linked to (defined benefit or defined contribution);
2. the type of employees in the plan (public or private sector);
3. the role, composition, and responsibilities of the different supervisory and executive bodies of a pension fund and the relationship between them (e.g. board of trustees and executive committee in the trust model);
4. the extent of delegation of managerial functions to third parties (e.g. asset management);
5. whether an active or passive approach to investment is used by fund managers;
6. the extent to which the prudent person approach to investment is in place.

- Analysis of the impact of governance structures on administrative efficiency: This component would aim to identify the main governance and investment issues that are relevant for closed and open funds in member countries. A literature survey on administrative costs would be carried out, following largely on the work started by the World Bank and other work quoted in DAFFE/AS/PEN/WD(99)17. Additional information may be collected as required.

- Pension fund governance, investment regulations, and performance: This component would consist of an analysis of how governance structures and external requirements of both closed and open funds condition pension fund investment management strategies. The work developed would also feed the Investment Regulation project that has been launched by the Insurance Committee and which covers both insurance companies and pension funds (see DAFFE/AS(2000)3). This component would in particular aim to:

- i. define the prudent person concept in fund governance and analyse its effect on investment strategies;
- ii. evaluate the effect that quantitative restrictions have on pension funds' diversification strategies and thus on the market value of their portfolios.

- Pension funds' role in corporate governance: This component would aim to collect information on the extent to which pension funds are allowed by internal and external rules and do in practice exercise their ownership and governance rights deriving from their investment in private corporations. It would also aim

to identify other obstacles to greater participation in monitoring of management by pension funds. Evidence would be drawn on whether closed pension funds, especially those linked to defined benefit pension plans, are able to take a more long-term approach to investment decisions and therefore play a more active role in corporate governance. All these issues would be discussed also from the perspective of cross-border investment.

43. The results from these studies would be used to develop recommendations on best practice in pension fund governance. These recommendations would be based on the final objective of pension funds, namely the provision of adequate levels of income at retirement. They would take into consideration whether the fund is of the closed or open type and whether it is managed by a public or a private sector entity. The recommendations would also include basic requirements to ensure that pension funds are suited to play an active role in corporate governance. Finally, they would take into account the policy implications arising from foreign investment by pension funds. The recommendations may then be set in a framework that offers an adequate balance between external regulations and internal statutes, which takes into consideration the impact of these rules on administrative efficiency, investment management strategies, and corporate governance.

44. For all these purposes, it may be conceived necessary to set up a task force dedicated to this and related studies on pension governance, as envisaged in (DAFFE/AS/WD(99)20).

#### **Linkages with other OECD activities on governance of and by pension funds**

45. The CMF launched at the occasion of its April meeting a study on corporate governance and collective investment instruments (DAFFE/CMF(2000)5). The proposed study would certainly gain from a close communication between the Working Party and the CMF. The Secretariat would endeavour to ensure that all questionnaires or other requests prepared for the proposed study are co-ordinated with those launched for by the CMF.

46. The study will also feed from on-going work related to general corporate governance issues, that are being conducted by the OECD Steering Group on Corporate Governance.

#### **Bibliography**

Davis, E.P. (1995), *Pension funds, retirement income security and capital markets, an international perspective*, Oxford University Press.

Faccio, M. and Lasfer, M. A. (2000), Do occupational pension funds monitor companies in which they hold large stakes, *Journal of Corporate Governance* 6(2000) 71-110.

James, E., Smalhout, J., and Vittas, D. (2000), *Administrative Costs and the Organisation of Individual Account Systems: A Comparative Perspective*, forthcoming in *Private Pension Series*, Vol. 2, OECD: Paris.

Smith, M.P. (1996), Shareholder activism by institutional investors: evidence from CALPERS, *Journal of Finance* 51, 227-252.

Wahal, S. (1996), Pension fund activism and firm performance, *Journal of Financial and Quantitative Analysis* 31, 1-23.