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Pension and National Reserve Funds: Governance Challenges from the Perspective of Emerging Markets

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This Discussion Forum touches on a number of issues critical to how we address the seemingly endless challenges of corporate governance. I would like to share with you some perspectives drawn from both (i) my own experiences in the private sector, particularly on pension funds management with Anglo American and the Altron Group in South Africa and (ii) my observations working across some 70 or so countries as Head of the Global Corporate Governance Forum.

➢ The Challenges that Confront Us

As a start, I would like to briefly dwell on some of the challenges and issues that confront us currently in framing my points on the extent to which **the pension fund industry can play an essential role in addressing some of the more critical governance challenges that face us** as we seemingly lurch from one financial crisis to the next with alarming frequency.

A striking feature of the past decade has been that many of the corporate governance "events" have occurred in the more advanced economies, bringing into question the presumptions on which our so-called international standards have been developed.

In my observation, this is beginning to create an interesting dichotomy between our commonly accepted presumptions and how some of the emerging markets look at these issues.

Whilst so-called advanced markets might be possessed by issues of a more "structural" nature like executive compensation, gender diversity and board independence for example; it is my observation that emerging markets are more possessed by matters of "market integrity" in respect of related party transactions, conflicts of interest and disclosure and reporting issues for example.

The overall principles on which corporate governance is premised is not necessarily in question, but certainly the emphasis is quite distinct and varied.

The notion of "independence" is probably an interesting case in point – in North America and Western Europe the issue rests more with independence from management, whereas in emerging markets it is much more about independence from the controlling shareholder or family.

As another example, **State owned enterprises** are a dominant feature of many emerging markets and have a significant influence over governance behaviours and conduct – as this often brings government into the heart of the discussion as they are often a player and referee. If you then extend this to the **sovereign pension funds** of China, South Africa, Malaysia, Singapore and others – the picture, potentially, gets ever more complicated.

Institutions in emerging markets for the most part remain weak or are poorly equipped to respond to the increasing complexity of so-called international standards and the need to conform to these requirements.

Add to this the fact that many of these institutions and regulating agencies lack any real form of independence. But, then again, perhaps that is not an issue exclusive to emerging markets if we look at some the issues that surround the SEC here in the US. I raise these points because they talk to the ability to effectively enforce good corporate governance practices and the increasing dependence on regulation to do this without the necessary capacity and skills, in many cases.

An aggravating issue in this context is the concern that **responses to the various crises are seeking to address market complexities that bear little resemblance to conditions and practices in emerging markets and developing countries but have a potentially profound impact on these markets**.

The broad similarities that may exist around corporate governance practices and standards in the economies of western Europe and North America that tend to define our international standard-setting efforts are not necessarily consistent across the increasingly important emerging markets economies of the BRIC countries, for example. Therefore, greater and more careful emphasis has to be given to aligning the relevance of these standards with local conditions, business traditions, laws and so on.

➢ The Unfinished Agenda: Looking Beyond the Regulatory Infrastructure

What is evident from the recent crises, is the increasing demand for regulatory intervention and the heavy politicisation of this process as we are seeing in Europe with an EU Green Paper calling for greater levels of legislation to enforce corporate governance, the Dodd-Frank legislation here in the United States and a multiplicity of initiatives around the world in places as far afield as Australia, the Philippines and South Africa, to name but a few.

An interesting development has been the **increasing focus on the role of institutional investors** and discussions around the regulatory framework under which pension funds are created, structured, and supervised.

Within OECD countries alone, the assets under management by institutional investors has more than doubled since the start of the 21st Century, with US$60 trillion in private institutional investments as of 2009 (compared to US$72 trillion in total bank assets).

I understand that the assets of sovereign investors amount to around US$10 trillion. What I find striking is that, according to the latest *Towers Watson Global 300 Survey* of the 10 largest pension funds at the end of 2010, six are sovereign pension funds with the largest being the Japan Government Pension Investment Fund [US$1,4 trillion] at nearly three times the size of Norway Government Pension Fund [US$550 million]. **These two pension funds alone dwarf some of the world's largest companies** by market capitalization, led by Apple and Exxon Mobil, each at around US$350 billion [as of September 2011].

It goes without saying, therefore, that private and official institutional investors are significant market players (and makers), and together represent a sizable source of global capital flows with important implications for global economic growth and financial stability.

It seems that regulation and enforcement of corporate governance is caught between two opposing poles: either the so-called principles-based or the rules-based approach (or, if you prefer, the UK versus the US model). From this basic departure point, complexities abound which have significant consequences for the course and the effectiveness of the strategies that we may employ to confront governance challenges.

Each of the two competing models—the rules-based and the principles-based—unfurls fundamental complications and limitations.

Under the **rules-based approach**, the issue is whether the regulatory infrastructure (at least in the emerging markets and developing countries where the Forum works) in fact has the capacity, skills, resources, and—more importantly—the independence to truly enforce the corporate governance rules and standards that sometimes quickly escalate in complexity and sophistication.

From our experience, the necessary skills and capacity to effectively discharge the regulatory mandate is perhaps among the most difficult challenges faced by emerging markets. It is a hurdle that arguably holds back the progress of many countries.

If we then look at the preferred method, which is more common throughout the markets where the Forum is involved, corporate governance is a **principles-based approach** which tends to be driven by a corporate governance code or a similar type of guiding instrument. The effectiveness of the principles-based approach, however, rests on a number of misguided assumptions:

- First, that there is already an effective enforcement regime in place in the country which reinforces the attitude towards compliance;
- Second, that there are local institutional investors who have both the capacity and the means by which to actively engage with boards and companies in an informed way (and are willing to do so!); and
- Third, that there is a free and informed business media that can comment and scrutinize company annual reports and public announcements to validate whether the expressed conduct of a company is indeed what it is claimed to be.

I think I can say, without fear of contradiction, that with very few exceptions – and these exist only in a few developed markets – these conditions have little or no universal conformity or even existence. The result is a **somewhat haphazard and often ill-informed basis of structures and regulations** that seek to prescribe corporate governance standards which are poorly enforced for reasons already given earlier or developed without appreciation for the necessary incentives required to encourage good corporate governance practices.

Frankly, these days it seems that this is as much a problem in developed markets as it is in developing countries.

The challenge we face is that the issue is being dealt with almost entirely from a top-down approach, whether you look at it:

- <u>via the rules-based approach</u> and the challenges it presents in terms of regulatory enforcement and the capacity and skills that are attendant with that, or
- <u>via the principles-based approach</u> which assumes that there is a set of market mechanisms that are operating consistently in terms of how each element of the market provides a measure of checks and balances.

So, where does this leave us in my proposition of the so-called “Unfinished Agenda”?

And, what to do about it?

➢ Salient Governance Challenges to Consider

The critical question for me is about coming to terms with **how much more can we continue to regulate boards**. How much more can we attempt to enforce rules that are largely directed in the form of laws and regulations – when, as observed, in the Walker Report in the UK that the problem wasn’t so much about lack of compliance but one of behavior.

From my perspective, while there arguably has been a necessary focus on the structural issues that drive better corporate governance practices through rules and regulations, this is only one part of a potentially much more complex equation. Often missing [in action!] has been the role that pension funds and their mandated agents, namely, fund managers and institutional investors, play in this all – not to mention the advisors on whom the pension fund trustees often depend.

The recent promulgation of the Stewardship Code in the UK provides a concrete step in this direction, which has been followed by South Africa and The Netherlands and I believe is under consideration in Singapore and Malaysia. It seems that this is also receiving the attention of Brussels.

Among a host of issues that I have the sense are only now coming to the fore are two trajectories to contemplate, which are:

(i) the extent to which **pension fund beneficiaries** are empowered to supervise the use of their pension fund assets in a way that assumes similar parallels to that of a shareholder, and

(ii) the closely related issue which touches on the caliber, **training and expertise of trustees themselves** in managing these assets in a way that dictates the governance priorities of the pension fund beneficiaries on a basis that delivers long-term value rather than implicitly stimulates short-term profit taking.

It is strange how the very fund managers, who participate in the call for independent and more professional boards of companies, are not necessarily subjecting themselves to the same strictures.

I should add that in the time I have available it is only possible to touch on a number of these issues, without dwelling in depth on each and every significant aspect as there are no easy solutions and various measures of complexity to contemplate.

Returning then to my earlier point, if in the context of a public company we insist on critical demands such as independent non-executive directors, qualified levels and tests of independence, experience, and expertise, and a vast menu of similar demanding criteria, **why do we not insist on these same principles and good practices when it comes to pension fund trustees**? The failure to do so is tantamount to perpetuating a dark gaping hole in corporate governance.

With few exceptions, this is not a discussion that takes place in any of the markets in which the Global Corporate Governance Forum works. And yet, a number of these markets are also the markets where the future of good corporate governance rests as more and more investors seek more rewarding havens than hitherto in the markets of Western Europe and North America.

The issue is **how to put in place a more effective process for trustees**. Why, for instance, do we not insist that pension fund trustees have the same attributes of expertise, professionalism, and knowledge that we expect of a board member of a substantial company? How is this issue stimulated more widely than a debate among the more developed and enlightened economies? Generally speaking, pension fund trustees will be appointed by the sponsoring employer and in some countries where unions have a right to nominate, it may include worker representatives too.

The crux of the issue, however, is that the general practice largely remains whereby **pension fund trustees are appointed on account of their affiliation or function, and not for their expertise**. The problem, of course, then escalates when it comes to decisions around how pension fund assets are to be invested.

At this point, one is confronted with people who are either unqualified or not capable of making informed decisions on a potentially complex area requiring considerable acumen and experience. The issue is not that they are incapable of making decisions, but it is not a job they look to with any measure of professional expertise.

In the case of worker representatives, it may even be that their main role is to protect the interests of workers which may not be aligned to the overall strategic interest of the pension fund. And, in the case of employer appointed representatives, their interest is sometimes more driven by management priorities than necessarily the best interest of pension fund beneficiaries.

All this brings us to another challenge: **the whole process of how investment decisions (or fund allocations) are made**. Either you will have trustees who in their own amateurish way will allocate funds—usually based more on an instinctive basis than through some informed process—or, they will hire an adviser to support this decision process.

The problem being that the whole process is ridden with potential for conflicts of interest and **lack of fiduciary accountability.**

The critical factor is how to engage both asset owners (members or pension funds) and fund managers (asset managers). Here the challenge is to make sure that the relationship between these two parties is appropriate and not lead to a situation where the contractual terms of the relationship serve the interests of the asset manager more than those of the asset owner.

Through the International Corporate Governance Network (ICGN) (an organisation representing some of the largest investors in the world reportedly with funds under management in the region of US$18 trillion), work has advanced rapidly in the formulation and adoption of the **Model Mandate Initiative** - which attempts to define a set of contractual terms between asset managers and asset owners to explicitly **define that pension funds are in charge of the investment chain process** and that they drive and control the terms of trade.

Fund managers should not monopolize the relationship, which obviously is not a helpful or desired situation for any of the players in the pension fund industry.

Equally inspiring is the current debate taking place through the **Cooper Review** in Australia, which raises fundamental questions about the extent to which the pension fund industry serves beneficiary interests.

A big aspect of this questioning centers on the **costs of pension funds**. But in asking tough questions, the process parallels the efforts of the ICGN Model Mandate Initiative in the sense that the common goal is that agents within the pension fund system should not be taking more than their fair value or to a point that erodes the return to beneficiaries and damages the effectiveness of the pension fund industry.

As already mentioned we are also witnessing a growing trend in markets around the world to adopt stewardship codes as an important means to instill a long-term mindset among investors. However, the task is a significant one.

We are **confronted by entrenched practices** in the investment industry that require careful consideration. The question is how this can be addressed, and led or inspired by whom? To what extent is it going to call for even more legislation to enforce the basic principles to “incentivize”, if you may, the key market players in this process to respond as envisaged – will that ease the challenge or introduce other unforeseen consequences? And, what are those?

While public sector and sovereign pension funds are best placed to respond, what of the **private sector fund managers that are often conflicted** through their affiliation within a banking or financial institution that are reluctant to possibly compromise other important (and sometimes higher value) commercial business and thus would not wish the fund manager to engage in issues that might be prejudicial to those interests?

Then there are a **range of pricing issues** related to the fees that can be charged by the fund manager to the pension fund, which like audit fees can be squeezed in a competitive bid or might even be dictated by regulated tariffs. This is often the more discrete aspect of why fund managers are passive, or service providers are contracted to undertake certain services such as proxy voting but, again, this is an area that has the potential for considerable conflicts of interest and then comes (once more) the question of the fiduciary capacity of asset managers to their principal, the pension fund and its beneficiaries (the asset owners).

If one only looks at the **Norway Government Pension Fund** for example - it has some 8, 000 companies in some 58 countries around the world in its portfolio! How can it honestly be expected to exercise its direct fiduciary responsibility to undertake detailed corporate governance oversight of its entire portfolio without incurring huge overhead costs that could arguably be detrimental to the performance of the fund?

While evidence seems to suggest that asset managers for the most part are not as actively engaged on corporate governance issues as might be believed, with some notable exceptions, this becomes even more acute in relation to their portfolio interests outside of their home market. This involves both structural and practical considerations, and in some instances can prove to be politically awkward as we saw some time ago when a German Minister described activist investors as “locusts”.

With **emerging markets** gaining significant interest among fund managers, given current conditions, how much more difficult will this be? But of even more concern is that in many of these markets, notwithstanding efforts on the part of government in Malaysia, for example, to establish the Minority Shareholders Watchdog Group, the role of domestic fund managers - whether from the public sector pension funds or from the private sector institutions – is generally passive with little or no stimulus from their underlying principals (namely, pension fund beneficiaries).

Question is, **how do we change the dynamics** of this and in what way?

In all that I have raised, more as food for thought, much is built on an environment where the pension funds (asset owners) and fund managers (asset managers) – generally speaking – operate in a reasonably well structured and ordered set of circumstances.

According to the latest *Towers Watson Survey*, only eight of the top 20 pension funds highlighted the relevance of building confidence with their members by increasing transparency to their members and disclosure of information. This **suggests we have some way to go** to address some serious shortcomings in an area that can inspire the oversight of better corporate governance – not just in so-called emerging markets but in many advanced markets. That has to be of great concern to us all!

In the emerging markets, many of the pension funds are poorly run, some have been plundered in the most egregious circumstances, and the role of pension fund trustees is one very much of “an absentee landlord” oftentimes!

But, even in emerging markets where the public sector or sovereign pension funds are reasonably functional, because it falls so clearly within government fiat it does then raise the spectre of how one addresses the level of **government suasion** in the way investment decisions are made and questions any focus on corporate governance as a priority issue.

In essence the challenge that continues to confront us is one where an asset manager is simply given a mandate to invest and perform at a level that matches an investment return that is equal or better than its peers - missing the whole incentive equation that would operate if such managers were mandated to invest but only in certain types of assets, in certain types of transactions, or by giving priority to particular practices of corporate governance or issues that would instill long-term mindsets and behavior.

If we can just seek to address this in a more concerted way, it may just start to balance out some of the challenges that confront us pretty much across most markets.

➢ Looking Forward…….

Institutional investors are one of the key players with the power and influence to change the direction and attention paid to good corporate governance practices.

Until we have a situation where asset managers, through the mandates that they are given by asset owners (pension funds), have in place thoughtfully considered and well structured mandates that define the way they invest "other people's money", the whole notion of corporate governance will remain a challenge for all of us – which, let it be said, regulations and laws alone will not fix.

It is also important that the role of active and engaged fund managers/institutional investors is more widespread, <u>and consistent</u>, as it is an area where the "free rider" problem is very apparent.

Without a vibrant institutional investor community, companies are simply not going to take corporate governance seriously – other than those that see the sense in it and are going to follow good corporate governance practices regardless.

But, this won't occur without enlightened and accountable trustees of pension funds responding to their fiduciary responsibilities to the pension fund beneficiaries in a thoughtful and well considered way.

This, to my mind, is an important element of corporate governance that is often absent.

The fall back position in the absence of effective self-governing mechanisms is too often, then, to call for more regulations and rules.

My own view is that **rules and regulations can only go so far** but will unlikely resolve the governance tensions and challenges that plague the financial markets system as we know it, unless you can finance huge capacity for regulatory supervision and enforcement which I very much doubt.

On the flip side, the emergence of stewardship codes and similar efforts like the ICGN Model Mandate Initiative clearly indicate that mindsets are shifting and that the current state of markets is making all players increasingly aware that this is an area that for too long has not received the attention it warrants – at least that is my opinion.

The questions that we need to address – from my perspective - largely centre on the necessary steps and actions that need to be taken to stimulate the **necessary responses to facilitate actions that will seek to address this important area of governance reforms**.