Investment of Social Security Funds: Issues and Experience

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1. Introduction

The following commentary is intended to provide a review, which, while not necessarily comprehensive, spans the range of aspects of issues which are relevant to the investment of, specifically, funds accumulated for the purposes of formal, nationally-sponsored social security schemes. In general, schemes which are funded in this sense would be schemes of the social insurance type, and it may bee useful to note the importance of making a clear distinction between *social* insurance and insurance of other kinds, usually commercial, or individually premium-rated arrangements. However, most of the commentary will be relevant to the – relatively unusual - case of a fund belonging to a social assistance scheme, in other words a social security arrangement other than one based on social insurance.

The commentary begins by reviewing a set of guiding principles for investment which are presented as representing, more or less, a universal standard. The following Section 3 sets out a list of the most common vehicles through which accumulated funds are generally invested, and Section 4 comments on some aspects of the need to manage assets and liabilities in such a way that certain characteristics are "matched". This issue is relevance to investment generally, but is of particular significance to social security funds, and especially those such as pension schemes that accrue very long-term liabilities.

Section 5 indicates the manner in which most managers of social security funds may be expected to approach the various aspects, while Sections 6 and 7 suggest some investment-related aspects of policy development and its implementation, respectively, which would be of special interest to the managers of social security funds.

2. Principles of Investment

The guiding principles of investment are usually stated in some way similar to the following:

- Seek the maximum yield or return;
- Minimise the risk (of loss of value of the capital invested);
- Ensure liquidity;
- Subject to all of the above, specific investments may be selected in accordance with broader criteria (for example national strategic or social objectives).

Experience indicates – strongly – that in the long run yields are correlated with the degree of "risk" (in a fairly specific sense) attaching to individual investments; in other words there is necessarily a "trade-off" between the first two of the guiding principles listed above. Those responsible for controlling and managing invested funds must, therefore, be in a position to specify their tolerance of the relevant risks.

The optimum approach is usually seen to require that a fund should "hedge" or diversify its investment strategy, but the way in which this is put into practice depends very much on the individual circumstances of the investor.

The controllers and managers of a fund must also – as indicated by the third of the guiding principles – manage the investments with a clear understanding of the timing of the cash flows which must be derived from the investments. This is an issue of particular importance when investments are made in physical properties ("real estate"). It is hard to justify a situation where a pension fund, for example, might invest heavily in major property developments, however good the returns may be "on paper", if the funds are tied up for many years in such a way that when members retire cash is not available to pay the monthly pensions on which those members depend, presumably, for their entire livelihood.

In a similar vein, although it is entirely legitimate for those responsible for social security fund management to consider proposals for using the funds to develop national infrastructure, which is of course likely to include socially-desirable projects such as the building of hospitals and schools, such decisions should not jeopardise the capacity of the fund to ensure delivery of benefits to all individual members on the day(s) on which they fall due.

3. Vehicles for Investment

The major divisions of investment types are usually categorized in groups as follows:

- "Fixed interest"
  - such investment include bank deposits, and loans of the investors money to, for example, governments or to corporate borrowers (such loans are sometimes described as "debentures" or "mortgages", depending on the availability of collateral security;

- "Equities"
  - these investments are those which the investor shares in any variation in the financial success of an instrument, whether favourable or unfavourable; the main examples are company shares, but also direct investments in property (or "real estate") also reflect in general a similar equity principle.

The distinction between these broad categories relates essentially to the basic capital invested; in the case of a fixed interest investment, the investor expects to receive interest payments during the period of the loan and to receive a return of the invested capital, intact, on termination of the investment. In the case of an equity-type investment, on the other hand, the investor will on termination of the investment generally receive back a sum which represents not the original capital, but the sum to which it has grown, or diminished, as a result of its use successfully or otherwise. It may be remarked, however, that the distinction between the capital return and interest receipts on an investment can be "blurred" to say the least, and may be altogether artificial, especially in conditions of high inflation which may impact severely on the *real value* of capital (although it may be necessary to maintain a careful distinction for accounting purposes, if funds are subject to differential taxation on capital and interest monies).

- Certain kinds of investment are not readily classified under either of the above headings. These include commodities (examples which might be found in the portfolios of pension schemes include gold or silver bullion);
- There is a growing trend in the more sophisticated investment markets to place investment monies in "derivative" instruments, including so-called "futures", "options" and increasingly complex schemes; investments of these types are by nature rather volatile, and so would be found only rarely in the portfolios of pension funds.

4. Asset and Liability "Matching"

Managers of investments must, rather obviously, pay regard to their assets and liabilities together. There are many aspects to this, but two are of particular importance for investors of funds with very long term liabilities, such as social security pension schemes (or provident funds). These are:

- The need to ensure that the fund will be able to meet its liabilities in the relevant currency of payment, which ability may be placed at risk if its investments have been made and denominated in alternative currencies;

- The need to ensure that the cash flows generated to the fund from its investment will be sufficient at all times in the future to meet the liabilities which fall due for payment.

Although the second of these may appear to be – and is – a restatement of the basic principle of liquidity, there are special considerations in relation to any fund which ahs very long-term liabilities, such as those of a pension scheme, because changes in financial conditions may have widely different impacts on the values of , respectively, the assets and liabilities, with serious potential risks to the solvency (in actuarial terms) of the fund.

5. Implications for Social Security Funds

The first point to note here is that social security funds, as they mature, almost inevitably grow to a size (quite possibly a substantial percentage of one year's GNP for the country) such that they dominate amongst investors in the domestic financial markets. They cannot therefore invest freely without themselves influencing the markets (particularly the trading of shares through national stock exchanges). In a few countries, including the United States, this has been thought to be unhelpful to the smooth development and running of the investment markets, and that for this reason some aspects of social security including retirement pensions should be provided through privately-, rather than publicly- managed schemes.

The majority of countries, however, have not taken such a strong view, but the choice of investments available to the fund managers is likely to be constrained, either by government regulation or in practical terms, owing to the inadequate supply of the types of instrument in which the managers would wish to invest. It has been not uncommon, in past years, however, for governments to direct managers as to the utilisation of the funds at their disposal, for reasons which may or may not have been well-motivated; some further comments on this matter are included in section 6.

Finally, it may be observed that there remain a few countries whose economies and financial markets are at a very early stage of development. These economies are unlikely to have the necessary "absorptive capacity" (whether in terms of the availability of securities in which to invest, or of investment in the real infrastructure of the country); in such cases the only practical option may be to invest funds outside the country itself – assuming that the necessary foreign exchange can be mobilized.

6. The Context for National Policy

As noted above, national governments have, in the past, often wished to direct the manner in which social security funds are invested. This may be to meet financing requirements for infrastructure development, quite possibly for social sector project such a construction of hospitals and schools. Alternatively, some funds have been required to invest in "social" housing projects. Experience suggests that the outcome of investment of this kind has almost always been very unsatisfactory as regards scheme finances, mainly because financial controls (for example the enforcement of rent collection in the case of social housing projects) cannot be rigorously applied. The "modern" trend is to strongly resist such models of prescriptive investment, and to focus on investing the fund in assets – as indicated in Section 2 - which may be expected to provide the best returns consistent with acceptable levels of risk to the invested capital.

There are, however, many other aspects of national financial policy and social conditions which may influence the investment and management of funds, just as strongly if in a more indirect manner. These include:

- The overall growth of the economy and its impact on rates of inflation; what is need for a social security fund is to maintain capital values and levels of income not in *nominal* but in *real* terms, i.e. after allowing for inflation, so that benefits paid to members represent allow the maintenance of real purchasing power;
- The demographic "transition" which is leading in many countries to a very rapid rise in the proportion of numbers of beneficiaries of social security retirement schemes, as compared with active contribution-paying members. The impact itself has a number of aspects, requiring an increasingly risk-averse approach to investment (to secure the real income of elderly

beneficiaries) and more obviously in the possible need to impose on wiorkers and employers higher percentage rates of contribution;

- In countries where only a minority of workers participate in the "formal" cash economy, governments may need to consider carefully "equity" between its citizens; this may in turn mean that governments may refuse to contemplate any kind of financial subsidy, however temporary, to schemes of the social insurance kind which would effectively jeopardise resources intended fro already disadvantaged members of society.

7. Some Aspects of Policy Implementation

The practical effects of the considerations set out in Section 6 are very broad in their scope. However, the prevailing financial ethos is important. In countries which have, historically, followed a centralised economic model rather than a "free market" philosophy, stock markets (and investment expertise) may, even now, be developed to only a limited extent. Moreover, the availability of investment instruments (for example company shares) will reflect closely the differences between countries which have progressed far towards industrialization as compared with those which have further to go in this regard.

The difference between mandatory and voluntary schemes must be kept in mind, although many national schemes are of course designed on a multi-tier basis and have aspects of both. However, it is quite strongly arguable that funds which have accrued from contributions collected on a mandatory basis should be invested in a manner which places greater weight on the principle of minimising risk as against that of maximising return; the latter may in turn be emphasised more strongly for funds which have been contributed voluntarily.

Finally, we may highlight a pair of issues which have attracted a great deal of attention in recent years and which have a major impact on the framework for investment of social security funds. These are:

- The pressures for "reform" of national pension schemes , in the light of ageing populations which – priming the "pensions time bomb" - have disrupted the patterns of funding envisaged for schemes which may have been designed many years ago; and
- The impact of "globalization" which has led to severe changes ion patterns of employment, but at the same time to new possibilities of economic growth and opportunities for remunerative investments in national markets.

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March 2002