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Partisan Politics and Bureaucratic Encroachment: The Principles and Policies of Pension Reserve Fund Design and Governance

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Key Words governance, encroachment, partisan politics, investment management
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Abstract. In an era of population ageing and increasing fiscal pressures on nation-states, pension reserve funds have been mooted as effective investment vehicles for realising future liabilities and achieving some balance between generations. Nonetheless, concerns have been raised that partisan political interests combined with bureaucratic encroachment are likely to adversely affect fund performance. In this paper, we consider the issue of design and governance beginning with broader issues of institutional legitimacy and autonomy before looking more closely at the management of these institutions with respect to holding partisan politics and bureaucratic encroachment at bay. We suggest a set of six core principles of design and another set of six policies of governance and management that we believe are essential to the functional performance of such institutions. These principles and policies are derived from previous research on pension fund governance and detailed analysis of four pension reserve funds that offer lessons for best practice. These principles and policies are not intended to provide funds with an absolute claim for independence; rather, the design and governance of these institutions should facilitate an effective and symmetrical relationship between the institution and its sovereign sponsor. These arguments are developed with reference to changing global financial markets, and the fact that the financial assets of these institutions are increasingly seen in the context of nation-states' total balance sheets of assets and liabilities.

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Introduction

Many countries have acknowledged the ageing of their populations through to 2050 and the likely demands that this will place on already scarce budgetary resources (WEF 2011). The funding of old-age pensions and the increasing burdens associated with the provision of healthcare services suggest that there may be politically unpalatable choices to be made between the competing claims of older and younger generations. In this context, the partial funding of Pillar 1 pension entitlements (e.g., Social Security, the Basic State Pension, etc) has been one strategy among many for minimizing future costs (and is seen as preferable to the discounting of future pension benefit entitlements in many jurisdictions) (Clark and Whiteside 2003). Pension reserve funds (PRFs) carry governments' commitment to pre-fund these types of entitlements and are, in effect, investment vehicles much like the supplementary pension funds so significant in Anglo-American economies (Clark 2000). Significantly, PRFs do not have explicitly estimated liabilities, as in the case of defined benefit pensions, nor do they have to concern themselves with pension adequacy, as in defined contribution pensions. As such, PRFs are a unique and distinct institution unto themselves, designed to strengthen public finances through an implicit pre-funding of public pensions and a policy to invest the associated assets in global financial markets.

Whereas a number of countries have followed the lead provided by Canada and New Zealand in establishing PRFs, commentators in some countries believe either that any long-term commitment to such an institution would not be politically sustainable and/or any related institution once established would be subject to partisan interests and bureaucratic encroachment such that its functional performance would be fundamentally compromised. These issues were widely debated in the United States (US) when the Clinton Administration considered various options for mobilising the assets of the Social Security Administration in the 1990s. In response, leading economists, including then chairman of the Federal Reserve Board, raised doubts about whether such an institution could be protected from partisan politics.[1] More recently, with respect to the US government's capacity to respond to the global financial crisis, Posner (2010) suggested that US political culture militates against long-term commitment.[2]

In a number of countries, however, governments have sought to design investment institutions robust enough to resist the siren calls of short-term political interest. In doing so, government sponsors have relied (in part) upon a distinctive institutional form that draws its legitimacy from modern portfolio management and the associated principles and practices of investment (see Merton and Bodie 2005). Just as importantly, a number of leading PRFs have developed innovative governance structures that have been deemed to neuter short-term political interest by reference to longer-term commitments including intergenerational equity; see Clark and Knight (2011) on the Australian Future Fund (FF). Here, we consider the issue of organizational design, institutional governance and management especially as regards to the issue of holding politics-at-bay. In doing so, we seek to identify the principles and policies of practice consistent with sustaining the integrity of these types of institutions in terms of realising their initial mandates and the longer-term commitments made by governments when setting their goals.

Our research is informed by previous related research on the costs and benefits of fund governance (Ambachtsheer et al. 2008). Here, we begin with institutional design assuming that the form of an organisation is, in part, a determinant of its responsibilities, the scope of its authority, and the deference owed or claimed by those deemed responsible for realising its mandate. As such, organisational form can be understood as a set of 'resources' which frames governance and the decision-making process. Whereas much of the social science literature on resource-based theories of the firm supposes that these resources are, in fact, unique to the enterprise, in this paper we suggest that institutional design can be replicated and imitated especially if it is deemed effective in realising commonly desired functions (see Clark and Urwin 2010; Merton and Bodie 2005). If organisational design sets the framework for decision-making, governance can be seen as the mechanism whereby decision-making is managed through the application of the available time, skills, and systems of deliberation. Elsewhere, we utilise the concept of a "governance budget" arguing that the effectiveness of an institution depends upon matching that budget against its risk budget (Clark and Urwin 2008). Many of the problems faced by public-sector investment institutions derive from 'incomplete' institutional form and 'inadequate' governance budgets.

The analytical logic underpinning the paper resonates with related research on strategic management and organisational behaviour (see Teece 2002 and Ostrom 2005). Here, we are concerned with the robustness of organisational form and the governance of decision-making in the context of the relationship between sovereign sponsors and their investment institutions. There are various types of public investment institutions including NPR's and sovereign wealth funds (SWFs). In this case, our focus is reserved for the former group of institutions, recognising that there may be implications for the design and governance of SWFs. Analysis is based upon four case studies: the Canada Pension Plan Investment Board (US$140 bn), the Irish NPRF ($23 bn), the New Zealand Super fund ($19 bn), and the Australian FF ($75 bn) (see Appendix). These institutions provide important lessons for the design of government-sponsored investment institutions, recognising that none is perfect. We emphasise principles and policies rather than the specifics of individual cases, believing that these types of institutions may become more important as governments promote public utilities to solve problems associated with supplementary pension systems (Clark 2011).[3]

Institutional legitimacy

One important claim for institutional legitimacy is the adoption of a recognised and widely accepted institutional form: a set of structures, rules, and norms that give shape to and provide boundaries for the realisation of organisations' roles and responsibilities (Summers 2006).[4] Elsewhere, we argue that sovereign wealth funds have attracted much interest around the world and have been adopted by so many countries because their institutional form is believed to be based upon uncontested principles and practices drawn from financial theory (Clark and Monk 2012). Whatever the history and geography of the nation-state, the principles and practices of finance are believed to provide, in sum, an uncontested blueprint for institutional form and function. This is especially relevant to PRFs, where government sponsors have sought to separate national long-term economic development through infrastructure investment and the like from portfolio investment in global markets and prospects in the hope of realising a premium on the national rate of economic growth and the 'local' government bond rate.

Given an accepted institutional form, legitimacy can be framed by reference to the sponsors' delegation of authority to the institution as well as the deference paid to the institutions' expertise and decision-making (Clark 2007). Indeed, the combination of an idealised institutional form with delegated authority and due deference to the exercise of those powers provides organisations, such as PRFs, the scope needed to be effective in global financial markets. Notice, the delegation of authority is actually comprised of three components: a mandate, constraints, and some form of accountability. By <u>mandate</u> we refer to the goals and objectives of an institution and may include, for example, a general purpose or objective of the institution as well as a target rate of return over some time horizon. By <u>constraints</u> we refer to any limits imposed by government on the realisation of the institution's mandate wherein those limits may reflect broader policy interests rather than statements of accepted principle. Finally, we expect that allocated delegated powers require well-specified mechanisms of <u>accountability and transparency</u> wherein the actions of the institution can be judged by third-parties against *a priori* goals and objectives.

Delegated authority is based upon, implicitly or explicitly, recognition by the sponsor that the actions taken by the institution in relation to its goals and objectives are owed deference. That is, the adoption of a certain institutional form with delegated authority can only be effective if the sponsor honours the initial commitment to the institution by deferring to its expertise, resources and knowledge, and its process of decision-making. In many instances, PRFs claim legitimacy by reference to the domain-specific expertise of its employees, the depth of resources and knowledge available to the institution, as well as the institution-specific process of decision-making, including the evaluation and adaptation of decision-making to changing financial conditions.[5] The distinction drawn here is between the generalised skills of government departments including Treasury as against the domain-specific skills and expertise needed to be effective in global financial markets (Clark et al. 2007). One consequence of the premium on domain-specific expertise is to be found in the apparent differences between the employment and compensation packages of government employees and the employees of PRFs.

Whereas the standard model of corporate governance seeks to reconcile the interests of agents in relation to the common interests of their principals (see Jensen 2000), it is arguable that the cacophony of political interests embodied in government necessitates a degree of delegation and a level of deference to the expertise of the PRF that few would contemplate as reasonable in the world of corporate governance. The formal framework sustaining delegation and deference needs to be robust enough to allow investment institutions to be 'flexible' in a manner consistent with Lo's (2005) characterisation of financial markets as 'adaptive markets'. The relationship between sovereign sponsors and their investment institutions is an important theme of this paper.

The governance problem

Given an idealised institutional form with delegated authority and claims for due deference to decision-making, it is reasonable to suppose that PRFs can withstand partisan politics. However, we should be more explicit by what is meant by partisan politics. At this stage, we can distinguish between three types or sets of political interventions that may compromise a PRF. Most obviously, partisan politics can be expressed in arbitrary decision-making, preferential decision-making, as well as corruption and malfeasance. Joining all three together is the notion that partisan politics may become unprincipled intervention where short-term political gain outweighs any larger claim about the virtue of long-term collective interests. As such, the delegation of authority may need to be deeply entrenched in legislation and in agency rules and regulations. But partisan politics can be expressed in a second way, such that the reconciliation of competing interests may result in a level of bureaucratic oversight, attempts to balance interests, and sensitivity to the electoral cycle that sponsored PRFs are slower to respond to the imperatives of financial markets than is optimal.

Preventing bureaucratic encroachment may require something more than delegated authority and expertise—in our research, the most successful institutions at keeping bureaucrats at bay were those that can reference an overarching and shared community commitment to long-term social welfare, whether or not expressed as inter-generational equity. Here, though, there is a premium on the process whereby shared community commitment to the goals and objectives of the institution are substantiated and integrated into the political system. So, for example, it is instructive that each PRF was established *after* governments had brought forward bipartisan inquiries and studies into ageing and its associated long-term social costs. In the Irish case, the legislation establishing the NPRF was brought to Parliament section by section with the opportunity for opposition parties to make known their concerns—they were invited to agree or disagree section by section as the legislation went through Parliament. In their different ways, the sponsoring governments also made significant long-term financial commitments when establishing their funds to demonstrate national (non-partisan) support to the forward-funding of pension obligations.

One way of articulating the political commitment implied by the establishment of a PRF is through the notion of a social contract. In societies with strong social democratic traditions, a social contract may resonate with existing commitments.[6] Where liberal democratic traditions dominate, the institution of contract may represent a moral and political agreement about the future (even if no Parliament can bind the hands of future parliaments). In contract theory, any commitment made about the future is a 'binding' agreement, albeit true that execution is subject to various conditions including economic and financial probity. To retreat from a contractual commitment is, of course, possible if some form of compensation is made to the affected party or parties. Whereas contracts are made and continuously remade amongst private agents, subject to tests of benefit and expectation, it is arguable that much more is expected of public agents when making "contractual" commitments to the future. As such, the arbitrary violation of forward commitments to the funding of a PRF may bring with it significant political costs not easily reconciled against immediate benefits.[7]

Of course, public and private commitments can be broken. In the private sphere, it is generally accepted that making and remaking contracts should be facilitated so as to promote the efficient allocation of resources. In the public sphere, the recent history of the Irish NPRF suggests that, in the end, the effective appropriation of NPRF assets was justified by *force majeure*.[8] Not only had circumstances radically changed in relation to economic conditions when the NPRF was established, honouring the independence of the NPRF would have violated the balance sought between the interests of current and future generations. In any event, continuing sponsorship of such an institution is only possible if government itself can reasonably claim to represent the national public interest in the context of global economic and political circumstances.

Relative autonomy

We have argued for governance structures wherein PRFs are insulated from unprincipled partisan politics and bureaucratic encroachment. We have also argued, however, that PRFs are unlikely to be insulated from fundamental changes in economic and financial conditions and the re-conceptualisation of the social contract or agreement that brought such institutions into being. We suggest that governance structures should be conceived in relation to the costs of partisan politics and bureaucratic encroachment rather than some absolute conception of institutional independence.

Nonetheless, our argument implies a significant level of institutional autonomy and a degree of independence not shared by many other governmental entities and enterprises. Once established, PRFs may become effectively self-governing institutions with considerable autonomy as to the management and organisation of their investment functions. When combined with an appropriate delegation of authority and due deference to their financial expertise, these types of institutions may claim unparalleled status relative to government. In response, government bureaucracies have sometimes sought to rein-in the effective autonomy of such institutions by appointing board members to balance expertise with representation. This is particularly apparent in public sector pension funds where the ethic of representation may include a wide variety of sponsors' representatives as well as other stakeholders (including unions, retirees, and current employees). In many cases, this has effectively stymied effective and responsive decision-making.

Recognising the costs associated with representation (as a constraint on power), enlightened governments have sought to enhance the decision-making competence of supervisory boards by itemising the qualifications needed for appointment. This is consistent with moves by a number of governments to establish nomination committees and lists of eligible appointees emphasising skills and expertise rather than political relationships or related claims for appointment. For example, in Australia the federal government has used this type of process to identify appropriately qualified individuals for appointment to the board of the Reserve Bank of Australia.[9] In effect, this type of process seeks to reinforce the independence of government-sponsored financial institutions, including PRFs, by appointing supervisory board members with domain-specific expertise as a mechanism for neutralising partisan politics and bureaucratic encroachment. By emphasising expertise over representation, governments have reinforced organisational effectiveness through the "joint result of … management decisions and board oversight" (Ambachtsheer 2011, 4).

In general, it is arguable that this is entirely consistent with the effective performance of PRFs. To the extent that these institutions are subject to rigorous tests of accountability and transparency, it is arguable that the public interest is served by favouring expertise over representation. However, this need not be a recipe for institutional independence. Most obviously, in some countries sponsored PRFs are of such a size that their international and domestic investments may loom large when financial markets come to price the risks associated with offered government bonds and countries' currency exchange rates. In these cases, the relationship between government Treasury departments and sponsored PRFs may be crucial in planning government fiscal and monetary policy. How that relationship is managed, including the role of PRF board chairs and representatives in relation to government Treasury departments, may be an essential component in maintaining the relative autonomy of sponsored financial institutions.

So, for example, recognising the increasing size and significance of their PRFs, governments have strengthened their capacity to understand the decision-making and actions taken by sponsored financial institutions. In effect, they have sought a symmetrical relationship with their sponsored institutions such that this relationship is governed by mutual understanding and acknowledgement of the nature and scope of respective responsibilities.

Design and management

In smaller countries vulnerable to the vagaries of domestic and global financial markets, the financial significance of PRFs has prompted governments to design constraints on the power and resources of these institutions. In some cases, enabling legislation has limited the PRF to holding a fixed proportion of government bonds and equities while denying the institution the opportunity to hold real assets and to take part in private equity investments that require private partnerships. In other cases, referencing the ideal form of such an institution, the enabling legislation requires the sponsored PRF to act as a global portfolio manager, shifting its investments to the global marketplace for opportunities and services. In these cases, the form and functions of the PRF mimic and match the protocols and relationships of the investment management industry.[10] For instance, PRFs are often required to follow the advice of their external investment managers when contemplating voting on issues related to corporate governance at home and abroad.[11]

In these ways, government-sponsorship may limit the growth of PRF internal resources including the competence and expertise of managers (as opposed to their boards). To the extent that this type of strategy is successful, the sponsored financial institution may be little more than a conduit for the financial services industry. This may be desired by government departments that perceive the PRF to be a threat to their historic relationships with relevant ministers; if the PRF was permitted to build up market leading skills and expertise in global financial market trading, it is highly likely that the PRF would soon cast long shadows over those government departments that might otherwise claim a similar level of expertise. Indeed, in many cases, the establishment of a PRF is effectively a vote of no-confidence in the existing skills and expertise found in the relevant government departments. To the extent that market-leading skills and expertise require employment contracts and compensation levels rather different than those found in government departments, it is little wonder that there may be significant bureaucratic resistance to providing sponsored financial institutions wide-ranging powers and responsibilities.

It is reasonable to suppose that smaller PRFs, no larger than established public and private pension funds, may be best managed as informed consumers of financial services. Here, the issues are entirely conventional and concern asset allocation, the assessment of manager performance, the oversight and management of portfolio risk, and the ongoing containment of costs in relation to the overarching long-term return objectives of the institution. However, with increasing size come increasing portfolio complexity and the possibility of searching for investment opportunities at the margins of markets. Both portfolio complexity and investment diversity require higher levels of skills and expertise in relation to understanding the nature of opportunities and the advice of investment consultants and in conceiving and implementing investment strategy. Furthermore, increasing assets under management may encourage managers to bring in-house complimentary functions otherwise provided separately by the external market for financial services. Cost efficiency may justify the internal development of investment functions.

Most importantly, increasing fund size in the context of a limited national market and a growing global market for investment may transform the institution from being simply a portfolio manager to being an opportunistic even predatory investor; the rather long investment time horizons of most PRFs may give such institutions considerable advantage in global financial markets otherwise overcome by short-term flux and flows. Government may persist in their attempts to constrain the growth and power of the sponsored financial institutions. But they would do so at some cost, especially when market following and reliant investment decision-making precipitates a level of volatility in performance that is hard to justify in the public arena. The legitimacy of the sponsoring government and the PRF may benefit from greater internal control over the investment process such that the realisation of risk preferences becomes the direct responsibility of fund management.[12]

Principles and policies of governance

Following on from our discussion of the design and governance of PRFs, in this section we distil lessons learnt from case studies and set out below a set of six principles of best practice. We recognise that these principles eschew the details of specific cases in the search for a template for institutional design and governance. The set of six principles match the approach used by Clark and Urwin (2008) wherein these principles refer to the core elements of institutional design and governance, which have broad applicability whatever the historical circumstances of the sovereign sponsor. We present the principles in order of significance; nonetheless, they are not easily separated one from the other in the sense that they reinforce one another and, in sum, represent the foundations for institutional design. As for the set of six policies, they relate quite obviously to the management and developments of an established PRF.

In some quarters, templates are scorned for their lack of historical and geographical specificity; as Gertler (2001) and Roe (2006) have noted, the establishment of an institution is necessarily embedded in historical commitments and past and present political compromise. At the same time, we also recognise that the funding of future pension entitlements has prompted many countries to search for solutions including models of institutional design and governance that have been tested and evaluated in other circumstances. As Stone (2008) observes, there is a vibrant international market for institutional innovation based upon inter-jurisdictional learning and the transfer of experience.[13]

Moreover, the principles and policies below are specifically tailored to the operational constraints of a PRF. While they may have utility for other institutions, such as the broad community of sovereign and public funds, we recognize that PRFs are unique and that their characteristics warrant special appreciation. In addition, readers will notice that these principles and policies are about realising PRF performance *in general* rather than articulating *specific* practices, as the latter are properly the responsibility of the governing body of the institution and the sponsor of the institution. We conceive these principles and policies as reinforcing the autonomy of the institution while also recognising the interdependent relationship between government and PRFs.

Core principles of design and governance

- *An overarching purpose*: the rationale for the organisation, referencing broad social objectives debated by the legislature and, if not unanimously accepted, acknowledged to have wide appeal in the community.
- *Mandate*: set out in the enabling legislation, providing clear guidance as to how the overarching purpose of the organisation shall be met including, where relevant, appropriate limits and constraints.
- *Delegated powers and due deference*: the formal arrangement of the institution's roles and responsibilities, where the boundaries of the organisations are demarcated and the scope of its expertise duly noted.
- *Accountability and transparency*: the formal mechanisms whereby the institution reports to its sponsor and related stakeholders, based upon both the institution's overarching purpose and mandate and underwritten by appropriate levels of transparency (reports, statements of transactions, etc).
- *Nomination and appointment*: the process whereby board members are appointed to the institution, typically based on a set of a priori expectations as regards candidates' expertise and experience particularly relevant to the functional domain of the organisation.
- *Employment and compensation*: the relationship between the institution's board and its management, providing a clear statement as to the board's responsibilities in hiring and firing senior executives and setting their compensation (inside or outside of the appropriate governmental guidelines).

Policies of governance and management

- *Sponsor authority*: wherein the authority of the sponsor in relation to the institution's mandate is clearly articulated especially as regards those officials of the sponsor who report to government and the legislature.
- *Board authority*: wherein the authority of the institution's board is clearly articulated both with respect to the board chair and the authority of the sponsor and with respect to the appointment and the terms of employment and compensation of senior executives.
- *Symmetrical knowledge and understanding*: concerning the relationship between the institution and its sponsor and in particular the knowledge and understanding of the sponsor in relation to the operations and performance of the institution.
- *Expertise*: intimately related to the institution's mandate and therefore its claims for delegated powers and due deference; the nature and scope of expertise may complicate its relationship to the sponsor especially in circumstances where the sponsor may neither understand the nature of expertise nor appreciate the price that may need to be paid for expertise.
- *Risk management*: recognising the long-term nature of PRFs' mandates but also public sensitivity about headline news of market losses (as opposed to returns), risk control and management is a vital task for PRF boards and may affect the functional scope of the institution, and the balance between internal and external investment management.
- *Force majeure*: if exceptions to an institution's roles and responsibilities cannot be reasonably identified at the time when the institution is established, the process whereby exceptions would be invoked should be foreshadowed if not in legislation then at least in the rules governing the relationship between the sponsor and the institution.[14]

By our assessment, the six core principles of design and governance are necessary conditions for the protection of any institution from undue political interference and are particularly relevant to issues of partisan politics and bureaucratic encroachment. So, for example, given its broad social objectives, a clear and unambiguous mandate for the institution is vital in circumstances where political interests and bureaucratic claims on the operations of the institution may seek to impose disabling limits and constraints on its activities.[15] In a similar manner, given delegated powers and acknowledgement of the deference owed to the institution's expertise, formal accountability and transparency are vital mechanisms for informing the sponsor and relevant stakeholders about the institution's activities without giving-up its autonomy. Finally, the nomination process, which results in the appointment of board members, should be seen as a means of realising the institution's overarching purpose through the oversight of realising the terms of the mandate. Again, to the extent that partisan politics and bureaucratic encroachment affect the appointment process, there is a test of relevance and expertise available to discipline this process.

Equally, the core principles of design and governance have an intimate relationship with the policies of governance and management. For example, the sponsor's authority should be consistent with the overarching purpose and mandate of the institution. Equally the delegated powers and deference owed to the institution articulated or implied by the enabling legislation may be seen as a constraint upon the sponsor's authority (and hence bureaucratic encroachment). At another level, given the mandate of the institution, its size and scope should also be consistent, such that realising its mandate may require a certain functional scope as well as a certain size of assets consistent with this sophistication or otherwise of the mandate itself. Notice, though, we would suggest that the institution's mandate may well determine the size and scope of the institution just as size and scope may be instrumental variables in realising the institution's mandate.

It may be argued that issues of policy are necessarily the responsibility of the institution and its board and, as such, do not have the same force or significance as the core principles of design and governance. However, the institution's relationship to the sponsor is rarely, if ever, one of autonomy and independence; in the end, the sponsor has the political authority to rewrite the core principles of design and governance. It may incur significant, and long lasting, political costs in doing so. As recent history suggests, governments are wary of going against institutions that have popular support for their social objectives.

Implications and conclusions

Fear of partisan politics and its effects upon the governance and management of financial institutions is a commonplace issue amongst OECD countries of both social democratic and liberal democratic traditions. The significance of unprincipled political interference on the performance of public sector pension funds has been well-recognised in the academic literature and elsewhere.[16] In large part, there is a fear of arbitrary decision-making, wherein it is assumed that partisan politics will seek out short-term advantage to the detriment of the institution's long-term purpose and mandate. We have argued in this paper, as well, that bureaucratic encroachment upon the decision-making and management of these types of institutions can also adversely affect performance. In turn, the institution may be limited or constrained in its actions, which in turn discounts the best intentions of the institution's board and its managers to realise its over-arching purpose.

Based upon detailed study of four exemplary pension reserve funds, we have suggested that a set of six principles of design and governance and a set of six policies of governance and management may provide these types of institutions with a formal structure and reference point sufficient to hold at bay the worst effects of partisan politics and bureaucratic encroachment. While framed with reference to pension reserve funds, these principles and policies are clearly related to previous work done by Clark and Urwin (2008) on best practice pension fund governance and may resonate with other similar types of institutions such as sovereign wealth funds, endowments, and even rate-setting national reserve banks. Notice, though, we do not mean to suggest that a pension reserve fund can claim a level of autonomy or independence such that there is no effective relationship between the sponsor and the institution. Our research suggests, in fact, that these institutions thrive when there is a symmetrical relationship between the institution and its sponsor such that both sides in the relationship understand one another's interests as well as the distinctive milieu in which these institutions must operate (compared to government owned enterprises).

In any event, as recent history shows, a number of these funds and other related public and private retirement saving institutions were caught-up in the turmoil occasioned by the global financial crisis. In one notable case, the assets of the pension reserve fund were thrown into the total accounting of national assets and liabilities for the purposes of bailing-out the nation-state and the impossible burden of failing private banks. It could be argued that this is an instance of partisan politics taken to the extreme; that is, some may have felt that even in the worst-case scenario, when national sovereignty was at risk, the pension reserve fund was owed its autonomy and survival, notwithstanding the costs to current generations. We are not convinced by such arguments. Whereas pension reserve funds are typically established, funded, and given their mandate so as to protect the interests of future generations, in cases where 'all bets are off', where *force majeure* dominates, any social contract binding the interests of current and future generations may have to be rewritten even to the detriment of future generations.[17]

More problematic, perhaps, are instances where at the design stage or in reaction to economic events and the changing balance of political interests in national government, moves are made to change the mandate of such institutions to add responsibilities that may constrain strategic asset allocation and investment decision-making. So, for example, to meet the interests of political parties necessary for passage of the enabling legislation, some governments have embraced notions of ethical investment, global standards, and responsible investment. As well, after establishment, some governments have added to their PRF's mandate responsibility to take into account domestic investment opportunities and possible joint ventures with the local venture capital industry. In yet other cases, especially in circumstances of severe budgetary constraints, nation-state sponsors have considered requiring their PRFs to make commitments to national infrastructure and development. These types of issues could be thought of as instances of partisan politics and bureaucratic encroachment on the delegated powers and due deference owed to pension reserve funds.

By our count, this interpretation could be entirely correct; that is, these types of claims may be expressions of short-term interests wherein political claims are made at the expense of the functional effectiveness of the institution. In these cases, it may be very important for the institution to stand its ground by reference to the principles and policies underpinning the overarching purpose of the institution. However, it may not be nearly as simple as this characterisation suggests. For a start, nation-states are sovereign entities whose legitimacy depends, in part, upon representing community sentiments that command widespread support. These commitments are often political but equally in a more abstract sense moral in substance. Equally, if there is a robust symmetrical relationship between sponsor and institution, there may be ways to fashion responses to claims made about the relevance of certain asset classes in the institution's total portfolio such that its delegated authority and the due deference made to its expertise are honoured.

Whether or not this type of institution survives and prospers depends on its functional effectiveness and not on whether it has an absolute claim of independence. Whereas this paper has focused upon the relationship between this institution and its government sponsors, it is important to recognise that functional effectiveness also depends upon institutional vitality and resilience. In this paper, given its focus, we have not had the opportunity to discuss the determinants of institutional vitality. Even so, as a couple of respondents have remarked, these institutions are effectively state monopolies with total control of their markets and without the threat of market entry by actual or potential competitors. If bureaucratic encroachment is a threat to their delegated authority and claims of due deference, being a monopoly may allow for a slow, almost imperceptible, process of creeping institutional scoliosis. Financial markets are unforgiving; but the costs of institutional inertia may only be exposed in moments of crisis. If so, the costs of institutional inertia may be felt by government sponsors but ultimately fall upon national social welfare.

Ultimately, sponsoring governments carry a heavy responsibility for setting the parameters governing their relationships with PRFs and similar types of organisations (including other types of sovereign wealth funds). Whereas we have emphasised the nature of this relationship in terms of sustaining institutional authority and due deference, a significant long-term research programme will also include as a vital topic the costs and benefits of government-sponsored investment institutions relative to the available options in the global financial services industry. Otherwise, comfortable mandates buttressed by easily attained risk and return targets may simply balkanise increasingly scarce financial resources, while discounting the long-term welfare of those that rely upon these institutions for their retirement income. In a sense, increasing reliance upon these types of institutions for public welfare is a remarkable experiment in institutional design and governance whose results will not be known for at least a generation.

Endnote

[1]/. See, for example, the comments made by Greenspan (1999) "I do not believe it is politically feasible to insulate such huge funds from government informants".

[2]/. In his account about the prospects for America in the aftermath of the global financial crisis, Posner (2010, 371) says, in part, "to maintain our economic position in the world may be especially painful and difficult because of features of the American political scene that suggest the country may be becoming in important respects ungovernable. The perfection of interest group politics seems to have brought about the situation in which, to exaggerate just a bit, taxes can't be increased, spending programs can't be cut, and new spending is irresistible."

[3]/. In terms of methodology, the reported research is based upon the protocols of social science governing field research (see Helper 2000). In part, this means that we eschew quoting directly respondents believing that insight and knowledge is best developed in conditions of trust and confidence.

[4]/. This notion of legitimacy is arguably consistent with Weberian conceptions of authority and control in modern democracies (Hardin 2006). Looking beyond liberal democracies, Dworkin (2011, 321) suggests that legitimacy of any government is based upon how it acquires power and how it uses power given an overarching responsibility to treat their citizens with "equal concern and respect." By this account, the legitimacy of any sponsored entity like a PRF is 'derivative' of the sponsor (in principle) but may be sustained against partisan politics by virtue of its actions in support of shared social goals and objectives.

[5]/. Following the lead provided by cognitive science and psychology, we believe that expertise is highly domain-specific — so much so that general (albeit high) levels of education may not be sufficient to sustain effective decision-making in environments that require judgement and calibrated experience. This argument is based in part upon Wagner (2002) and is developed with reference to investment decision-making in pension funds and related institutions by Clark et al. (2006, 2007).

[6]/. This logic finds expression in arguments about the nature of pay-as-you-go pension systems which require an accepted means of integrating past commitments with future obligations between generations (see De Deken et al. 2006). In a more holistic fashion, Pettit (2002, 277-78) suggests that the design of an institution should, in some way map onto existing social norms and expectations so as to take advantage of those norms and expectations in disciplining claims that may seek to violate the best interests of the institution.

[7]/. This brief discussion of public and private contract subsumes debate in the literature about the nature and status of contract. For some, there is an intimate relationship between promise-making and contract such that the former is the foundation for the latter. Here, we have suggested a notion of private contractual relations that emphasises separate and mutual benefit rather than moral commitment, believing like Kimel (2002, 2003) that the contract institution stands in place of moral foundations because of the nature of market exchange. On the other hand, we also suggest that much more is expected of the nation-state in that it may be seen to represent social and moral expectations notably less evident in private exchange. Put slightly differently, whereas private contracting is a process, public contractual commitments embody substantive moral values.

[8]/. The status of *force majeure* is widely debated. For some theorists, it is of doubtful value in that, surely, contracts are made precisely to hold time still; that is, in anticipation of changing circumstances and the easily-made compromises that may be prompted by such events (see Atiyah 1995, 243). By contrast, Williams (2002, 112) suggests that it is probably better to conceptualise contacts as intentions breaking the claimed nexus between moral right (promising-making) and the world of events and commitments. As such, the test of commitment should be found in the net benefit to society (in a manner consistent with Dworkin 2011).

[9]/. See the report in the Australian Financial Review (January 8th, 2011 pp. 1 & 6). While appointment to the Australian Future Fund is also subject to tests of expertise and relevant knowledge, it is not yet subject to the type of nomination procedures and vetting for political interests apparent in the assessment of candidates for appointment to the Reserve Bank of Australia.

[10]/. See, for relevant expositions, Davis and Steil (2001), and Morrison and Wilhelm (2007).

[11]/. In this respect, as with SWFs, governments have sought mechanisms for discounting any apparent relationship between their interests as sovereign nations in the community of nations and the actions of their financial institutions in seeking to affect the governance and economic policies of other countries' domiciled large corporations. The contentious nature of the issue is reflected in the experience of CalPERS when excluding whole countries from their investment portfolios (Hebb and Wójcik 2005) and Norges Bank Investment Management (NBIM) in excluding major corporations from their investment portfolios on the basis of ethical criteria (Clark and Monk 2010b).

[12]/. Portfolio managers manage risk in relation to short-term measures of the variance in returns as against accepted benchmarks. By contrast, it is not obvious that PRFs, which have long-term mandates without reference to liabilities, should conceptualise risk in the same way—operationally, some such funds have set 5 year and 10 year time horizons, discounting 'short-term' volatility. At the same time, recognising their public responsibilities, other risk factors have been drawn into the equation including issues of long-term sustainability and global stability. Even if the boards of PRFs are insulated from immediate political pressures over rates of return, public commentary on this issue may also affect the management of risk.

[13]/. This is, of course, the mission statement of the Rotman International Center for Pension Management. More generally, the adoption of some ideal institutional form against inherited tradition is a deliberate commitment to perfection and a claim that global integration requires a break with the past.

[14]/. See, for example, the process of dealing with 'exceptions' found in the enabling legislation empowering the Singapore Government Investment Corporation (GIC). We show with reference to recent experience of the global financial crisis, the government of Singapore could not arbitrarily change the mandate of the GIC without observing the procedures whereby these changes were approved (Clark and Monk 2010b).

[15]/. The notional hierarchy of principles, which begins with social objectives and is articulated through an explicit, well-defined institutional mandate seeks to join together political legitimacy for the institution with a recipe for effective functional performance. Like those writing on corporate governance (see Jensen 2000), we believe that functional performance is best achieved if governed by a clear, simply comprehended objective function. However, that objective function must be a reflection or articulation of the broader social goals that legitimate the institution. In this respect, there are significant differences between public and private organisations such as corporations.

[16]/. See, for example, Hsin and Mitchell (1994) and Mitchell and Hsin (1997).

[17]/. Notice, though, this possibility could be contingent upon the constitutional form of government and whether it is, like Ireland and the UK, a system wherein the national government is the ultimate decision-maker or whether powers are formally shared between national and provincial and state governments. It may be very difficult indeed for some types of national governments to claim authority over state and provincial financial assets when the institutions holding those assets are 'located' at a sub-national jurisdiction in a manner formally recognised in a constitution. Posner (2010, 383) identifies this feature of American democracy as an "eighteenth-century" impediment to effective government.

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Appendix: case study reports

Investing National Pension Contributions: The Canada Pension Plan Investment Board

Background: When the Canada Pension Plan Investment Board (CPPib) was created in 1998, political interference with, and other influence over, the investment operations of the fund were identified as major concerns: "The main fear was that a federal government might try to raid the fund at some future time to suit its own purposes," according to former Prime Minister Paul Martin (who was Minister of Finance when the CPP was reformed and the CPPib was created). Indeed, according to CPPib President and CEO David Denison, "Canadians made it clear that while they were willing to accept a higher contribution rate, they were distrustful of leaving their pension funds under political control." As such, the architects of the CPPib designed an institution with numerous checks and balances that keep the assets far from politicians' reach.

The recent financial crisis has provided a useful stress-test of these governance procedures, as cash strapped politicians might be expected to see the CPPib as a ready storehouse for stimulus funding or money for 'directed investments'. However, according to its 2009 annual report, "CPPib's governance model, which was designed to ensure that the CPPib could operate at arm's length from governments and free of political interference, held firm." Indeed, one CPPib employee told us, "This was a stress test, and nobody knocked on our door thinking they could divert our funds for other purposes." As such, the CPPib offers a useful case study in our project to understand the 'best practice' principles and procedures needed to prevent political interference within social security investment funds. The most important design characteristics of CPPib are described below:

Mandate: The *Canada Pension Plan Investment Board Act* was the founding legislation of the CPPib. Enacted in 1997, it gave the fund a singular mission to contribute to the long-term sustainability of the Canada Pension Plan, and it rejected all extra-financial (political, environmental or social investment objectives) investing that might hinder the fund in achieving this objective. In short, the fund could only legally be used to pay CPP benefits and other expenses. Moreover, the *Act* gave the

CPPib independence from the 9 provincial governments and the federal government, which are the stewards of the fund. Indeed, the fund is not owned by any of these governments, but, instead, is technically property of its 17 million members.

Changes to the *Act* and CPPib's investment mandate are very difficult, requiring the agreement of the federal government and two thirds of the provinces representing two-thirds of the population. To put this in perspective, this is a level of exigency greater than that to change the Canadian constitution. As such, directed investments or any other changes to the investment policy could only take place in (truly) extraordinary circumstances.

Governance: Given the reliance of CPPib on its Board, selection of members takes on added importance. The governing statute specifies that Board members should have the requisite finance and investment expertise and formally excludes from the Board government employees and politicians. In terms of nominating individuals, CPPIB provides assistance in the identification of desirable director competencies and retains and manages an executive search firm to source qualified candidates for consideration, which it then forwards to an external nominating committee composed of federal and provincial representatives with some private sector involvement. This committee then decides which names will be forwarded to the federal finance minister. Subsequently, the federal finance minister makes his or her recommendation, after consultation with the participating provinces, to the federal Governor in Council, who in turn makes the formal appointments to the Board.

The Board, the CEO, the senior management and all professional staff are bound by a strict code of conduct that, among other things, specifically requires them to notify others if they are subjected to political interference of any kind. Additionally, the code of conduct requires directors and senior officers to stay out of all outwardly political activity that would be deemed incompatible with their ability to carry out their duties in a 'politically impartial fashion or cast doubt on the integrity, objectivity or impartiality of the CPP Investment Board.'

The architects of CPPib enshrined in the CPP legislation a 'fail safe' mechanism to automatically maintain the CPP's financial stability (and avoid the need for political involvement should the pension suffer significant losses). Indeed, the legislation prescribes automatic increases in contributions and cuts in benefits to deal with shortfalls identified by the Canadian Chief Actuary over a 75-year period (see Monk and Sass 2009). This approach has recently been adopted by the Government of Quebec so as to ensure the sustainability of the Quebec Pension Plan (see the March 17th, 2011 Quebec budget papers and the document "A Stronger Retirement Income System" available at www.budget.finances.gouv.qc.ca/budget/2011-2012).

Transparency and Accountability: As a 'federally administered' entity, the CPPIB is ultimately accountable to 9 provincial governments (Quebec does not participate) and the federal government. However, the direct involvement of these governments in the CPPib's activities is strictly limited. For example, the CPPIB does not submit its investment strategy or business plans to governments for approval; it does not have any government officials sitting on the Board; and it does not submit any compensation policies or pay levels to the government for approval. Rather, implicit accountability resides with its Board, which appoints the CEO and other senior officers, oversees the investment program and has final say over management issues, benchmarks, and risk limits (among many other things).

Crisis and Response: Compared to the US, the global financial crisis was not nearly as significant for Canada (in part because of the funding and regulation of national banking institutions). In any event, the CPPib is a hybrid public-private institution. The federal government administers the CPP, but the assets in the CPP do not belong to the federal (nor the provincial) government. Its assets are strictly segregated from all government accounts and are legally owned by CPPIB. As such, CPP benefits are paid in accordance with the CPP legislation, but the federal and provincial governments are not plan sponsors nor do they provide a residual guarantee, and the net assets of the CPPib are available to satisfy CPP obligations in accordance with the legislative scheme (noted by Steven James, per com.). Consequently, CPP finances in no way affect government budgets, as is the case with public pension funds at the state and local level in the United States.

Implications and Conclusions: The CPPib's governance system is widely viewed as successful in meeting its objective of ensuring the independence of the CPPib from political influence and interference. As such, it offers an interesting case study on how government-sponsored entities with a mandate to invest in risky assets should be designed. Moreover, interviews with CPPib representatives (and stakeholders) indicate that the Board has never had to fend off any political interference, including during the most recent crisis. In fact, public debate suggests that governments might, in fact, expand the remit of the CPP (and thus grow the CPPib) due to the robustness of the CPPib institution (and the demise of private DB pensions). How did the CPPib achieve this status? Many people credit the fact that it's a relatively new institution, which means the fund was constructed using best practices rooted in established theory and empirical knowledge of what works and what does not work. Today the CPPib is, in the words of many of our interlocutors, a "sacred cow". Politicians will look to misuse CPP assets at their own peril.

Pension obligations and intergenerational equity: Australia's Future Fund

Background: As Australia became integrated into Asian and in particular Chinese economic development, the national government began to accumulate significant budget surpluses. Rather than distribute these surpluses to current taxpayers, in an economy already at full employment with the prospect of a housing property boom on the horizon, the Future Fund was launched as a means of absorbing those surpluses to partially fund the long-term pension obligations of the Commonwealth government vis-a-vis its public servants.

In justifying the Fund, the Treasurer noted the long-term costs associated with an ageing population and committed the government to intergenerational equity—an accounting framework that seeks to balance the costs borne by current and future taxpayers. The government explained the design and governance of the Fund in relation to international best practice. It also sought to distinguish its investment mandate from that of a project developer aimed at sustaining long-term economic development. Whereas the Labour opposition promoted investment in infrastructure as the proper use of government surpluses, the Future Fund was conceived to be a portfolio investor. The change of government in late 2007 did not alter this commitment.

Mandate: The objectives of the Fund are set out in the enabling legislation, being "to enhance the ability of the Commonwealth to discharge unfunded superannuation liabilities". Thereafter, Section 18 of the Act provided first that "ministers may give the Board written directions" subject to (2)(a) "maximising the return earned on the fund over the long term, consistent with international best practice for institutional investment". Furthermore, responsible ministers may provide direction in matters related to risk and return, and the allocation of financial assets. Note, Section 18(A)(1) provides that responsible ministers cannot give direction to the Board to invest directly or indirectly "in a particular financial assets", "a particular derivative", or "a particular business entity", "a particular activity", or "a particular business".

Governance: Following the lead of the New Zealand Superannuation Fund, board members were designated "Guardians" and are together the "body corporate" with the responsibility and "power to do all things necessary or convenient to be done for or in connection with the performance of its functions". Consistent with similar types of organisations, board members are required to discharge their duties in a manner consistent with fiduciary duty and other related civil obligations and requirements as to honesty etc.

The board is comprised of a chair and six other members appointed by the responsible ministers providing members have "substantial experience or expertise", "professional credibility and significant standing; in at least one of the following fields: (c) investing in financial assets; (d) the management of investments in financial assets; (e) corporate governance."

The Chair of the Board was identified in statute as responsible for managing the Fund on behalf of the responsible ministers and the chair was designated as "Head" and "Chief Executive" of the Fund Agency. Furthermore, Part 5, Section 79 provides that "to avoid doubt, the chair is not subject to direction by the board in relation to the Chair's performance of functions, or exercise powers"... "in relation to the Agency."

Transparency and accountability: The Fund publishes an Annual Report with details as regards its operations, investments, and performance for the separate funds that constitute the Fund. The Future Fund is required (if asked by the responsible minister) to provide reports on specific matters within a specific period of time, and is required to keep responsible ministers informed about the operations of the board (in effect, the Fund).

Investment management: The investment programme of the fund began in the 2007/08 financial year. With an initial cash contribution from the government of $51.3 billion, and shares in the government-owned telecom valued at approx. $9 billion, the Fund began operations with about $60 billion. The Board interpreted its mandate as seeking the return of at least CPI+4.5% return per annum over the long term (a rolling ten-year window). As for its risk budget, the Board rejected benchmarking fund performance against other institutional investors and sought to ensure the conservation of capital against the prospect of poor returns over the following three years.

Rather than rely upon public equity markets and related products and providers, the fund sought to invest in alternatives and tangible assets so that only about one third of assets were committed to listed equity markets. In terms of its allocation of investments by jurisdiction (geography) as of 30 June 2010, 40% of assets were committed to the United States, 35% to Australia, 10% to the rest of the world, 7.5% to Europe (ex-UK), 5% to the UK, and 2.1% to Japan. The fund has taken positions in infrastructure, timberlands, debt and related alternatives. Because it is not able to hold directly or indirectly property, it has invested in actively managed investment property portfolios.

Overall, the fund has sought to remain flexible so as to take advantage of opportunities thrown up by "dislocated markets". In this respect, recognising that many institutional investors are subject to rather structured strategic investment policies, the fund has sought to take advantage of its unique time horizon as well as its philosophy of risk budgeting.

Crisis and response: As is widely appreciated, Australia has not suffered through the global financial crisis as has many other advanced Western economies. Given its immense cash holdings at the onset of the crisis, and given its caution in relation to the conservation of assets, the loss for the period

2008/09 was in the order of -4%. Thereafter, the fund benefited from the recovery in financial markets and its distinctive investment strategy.

With the election of a Labour government in late 2007, questions were raised as regards the commitment of the incoming government to the philosophy and underlying objectives of the Future Fund. With a cash surplus of $19.7 billion for 2007/08 and a second tranche of receipts from the sale of the telecom, the new government established a number of "Nation-Building Funds" whose assets were allocated to the Future Fund to invest on the government's behalf. These funds came into existence 1 January 2009 with commitments of $10 billion to the Building Australia fund, $6.5 billion to the Higher Education Endowment Fund, and $5 billion to the Health and Hospitals Fund.

In the context of the global financial crisis and the budget stimulus package announced by the Labour government in early 2009, $1.6 billion was withdrawn from the Building Australia fund, $1.3 billion was withdrawn from the Education Endowment Fund, and $450 million was withdrawn from the Health and Hospitals fund. The core funding of the Future Fund was not affected.

Implications and Conclusions: The Future Fund represents the commitment of Australian government to intergenerational equity, balancing political opportunism against future generations' interests in the funding of current commitments. It is the product of a remarkable surge in national prosperity linked with the economic growth in China. With budget surpluses has come the opportunity to meet political interests that may have otherwise been antagonistic to sustaining the place of the Future Fund in the national polity.

With the onset of the global financial crisis, the Labour government introduced an economic stimulus plan in part funded by assets withdrawn from the Future Fund's endowment funds. In this respect, the Labour government used the Fund to "shelter" its endowment funds and then used those funds as bank accounts whose assets were deemed available to be withdrawn in moments of need. The government effectively reinforced the legitimacy of the Future Fund, distinguishing its core assets from those that might otherwise be held by the government treasury reserve fund.

Investing for the Future: the integrity of the Irish NPRF in the context of the global financial crisis

Background: In introducing the legislation establishing the Irish National Pension Reserve Fund in 2000, the then Minister for Finance noted that "Ireland is set to experience a significant ageing of the population over the coming decades." The fund was conceived to partially underwrite the forecast costs of providing national PAYG pensions through to 2055. Previous government reports (1998 and 1999) had considered the issue of looming pension liabilities in the context of a rapidly increasing dependency ratio. In establishing the NPRF, the government made an initial allocation of £5 billion using a large tranche of assets from the sale of the state-owned telecom, and thereafter a yearly contribution of 1% GNP. Legislation prohibits the government from drawing-down on NPRF assets through to 2025.

The Minister for Finance made two commitments: the fund would be operated as an 'independent' but sovereign entity, and the government's yearly contribution would not vary over time, whether because of changing government priorities or in the face of changing economic circumstances. The Minister believed that "the government of the day should not exert any influence on the fund." When pressed by the Select Committee on Finance and the Public Service (8 November 2000), the Minister of Finance noted that "I am putting aside funds which belong to the people away from the control of the Minister of Finance" and "I strongly believe that this pension fund should be regarded in the same light as a person's private pension fund or the pension funds of a company".

Mandate: While conceived to partially fund forecast national pension liabilities, the fund neither holds nor recognises those liabilities in investment decision-making. Specifically, the legislation provided for "a strictly commercial investment mandate for the fund with the objective of securing the optimal return over the long-term subject to prudent management". Commission board members are required to honour the NPRF's mandate in ways *consistent* with the principles of fiduciary duty, although they are not legally fiduciaries.

Governance: The NPRF Commission is the governing board of the fund. The board has 6 members including the chair, plus the CEO (ex-officio) of the government's NTMA (National Treasury Management Agency). The NTMA was nominated in the enabling legislation (2000) as the 'executive' of the Commission for the first ten years given its professional competence and knowledge of the financial industry. In Parliament, the Minister of Finance distinguished between the NPRF and the NTMA noting that the latter is an arm of the Ministry.

Appointment as a NPRF Commissioner is at the discretion of the Minister and is based upon a person's "substantial expertise and experience at a senior level". Those eligible to be appointed include professionals from the finance and pensions industries, the civil service, unions, and consumer protection. The current board includes three Irish businessmen, an academic, and two international experts with significant reputations in investment. Appointments are for 5 years in the first instance, involving a minimum of 4 meetings a year, with an annual fee of approximately €40K.

Transparency and Accountability: It publishes an Annual Report which is required to provide detailed information on activities and trading, quarterly performance reports, news updates and the like (on the website). The Chair of the Commission and the CEO of the NTMA are required to attend the Parliamentary Select Committee on Finance and Public Service once a year. Nonetheless, it is deemed 'independent' of the party political process and the Government of the day by virtue of its mandate and the enabling legislation.

Investment Management: As noted above, the NTMA is responsible to the Minister of Finance, but has a career structure, salary scale, and professional identity distinct from the government civil service. For the NPRF, it provides all functions and services, including a secretariat that supports the chair and the board of commissioners. The NTMA manages the external investment managers of the NPRF. This arrangement was intended to last for the first 10 years of the fund; currently, there is discussion about renewing the NTMA mandate.

Given the long-term objectives of the fund, investment strategy is framed with reference to a five-year time horizon and market conditions. Asset classes include equities, bonds, and alternative asset classes with a mix of active and passive management strategies. At the time the fund was established, it was recognised that because Ireland is a small economy in relation to the global economy, investment would be largely in overseas assets. As well, the fund was prohibited from investing directly in Irish government securities. At the time, 'responsible investment' was deemed inconsistent with the unfettered responsibilities of the fund.

Crisis and Response: The Irish economy grew strongly over the first decade of the 21st century but was dramatically adversely affected by the global financial crisis. With the crisis also came a banking crisis, a credit crisis, the collapse of the property market, and rapidly increasing unemployment. Failure to recapitalise the banks would have precipitated a sovereign debt crisis.

After attempts to stabilise the banking system, the Minister of Finance sought to instruct the NPRF to "invest" in the Bank of Ireland and Irish Allied Bank. To do so, the government returned to Parliament with amended legislation distinguishing between "directed investment" and the assets available to the fund for portfolio investment. Recapitalisation involved an initial commitment of €7bn to the banks through the allocation of preferential shares to the NPRF with the coupon value of 8%: €4bn was allocated from the NPRF's assets and €3bn was provided by the government by forward-funding two years of its 1% GNP annual commitment. Thereafter, as part of the bail-out package, the NPRF's stake in the banks rose to €10bn with another €10bn of its assets set-aside to help fund the national government's contribution to the bail-out package. As of 2011, €5bn in a global diversified portfolio was left to the NPRF to manage on its own account.

In the 2009 amendments to the NPRF legislation, the Minister reserved powers to direct the NPRF to undertake other investments, while providing the NPRF the option to create special purpose investment vehicles. In response to pressure from the government's coalition partner, it also changed the legislation to explicitly allow for a 'responsible investment' policy in a manner consistent with the practice of a number of sovereign wealth funds. Subsequently, of course, the government lost the 2011 election.

Implications and Conclusions: it is arguable that the NPRF failed the ultimate "stress test". However, this would not do justice to the sovereignty of Parliament, the force of unexpected circumstances, and the fact that the NPRF has now an ownership stake in two banks that are at the heart of the Irish economy. Even so, the NPRF does not directly 'manage' its stake in the banks (this being the responsibility of another division of the NTMA).

The government sought to honour the 'spirit' of the legislation establishing the NPRF as a portfolio investor rather than a government investment agency. However, declining government revenue, claims from those most affected by the crisis, and commitment to EC deficit reduction targets, meant that the government used the NPRF to underwrite its bail-out of banks (treating 'ownership' as its yearly 1% GNP contribution). Even so, with the accelerating Irish sovereign debt crisis and the prospect of contagion across Euro-land, the EU and IMF rescue plan for Ireland effectively absorbed the assets of the NPRF into the national balance sheet of assets and liabilities. It remains to be seen whether the NPRF is able to sustain its mission and its hold over 'its' assets.

Blueprint for the future: the design and governance of the New Zealand Superannuation Fund

Background: New Zealand provides a universal pension subject to taxation and funded on a pay-as-you-go basis from general taxation. Established in 2001 by the then Labour government, the New Zealand Superannuation Fund (NZSF) was conceived to be an arms-length investment institution whose purpose it is to invest government contributions to the fund so as to anticipate the future government liabilities that will come due with the retirement of the baby boom generation. With an initial government contribution of $2.6 billion in 2003, the government contributed about $2.5 billion each year until contributions were suspended in 2009 by the newly elected National party government. Current estimates put the value of the fund at approximately $18 billion (December 2010).

At the time of its establishment, NZSF was conceived as a Crown entity like a number of other Crown entities and state-owned enterprises established for specific purposes—in large part, being a Crown entity has provided NZSF certain advantages, including tax exemptions on investment returns (not available to private investment institutions), as well as an implicit government "guarantee" as to its commitments and obligations. Note, in the final years of the Labour government (2007–2008), KiwiSaver was established so to be a "top-up" supplementary DC pension scheme based upon modest member contributions, matching employer contributions, and tax benefits. The current government has discounted promised benefits and costs of KiwiSaver.

Mandate: As with other similar institutions, NZSF was conceived to partially fund forecast national PAYG pension obligations. It was also, at the time, conceived to be a shared commitment by New Zealand political parties to forward funding of PAYG pension obligations. In parliamentary debate, and in the passage of the separate parts of the bill establishing the fund, opposition political parties were invited to sign up to the initiative. More specifically, the Guardians of the fund were charged with the responsibility to "invest the fund on a prudent, commercial basis, and in doing so… manage and administer the fund in a manner consistent with (a) best practice portfolio management; and (b) maximising return without undue risk to the fund as a whole; and (c) avoiding prejudice to New Zealand's reputation as a responsible member of the world community."

Governance: Board members of the Fund were deemed to be "Guardians" rather than trustees and are the entity responsible for the management of the Fund in relation to its formal objectives. The chairman of the board and the six guardians are responsible for hiring the executive of the fund, its management and performance. The Minister of Finance appoints the Guardians to the fund, based upon advice provided by the nominating committee which is comprised of four or more persons with "proven skills or relevant work experience". Any person appointed to the board must be suitably qualified in that he or she should have "substantial experience, training, and expertise in the management of financial investments". It is also expected that the Minister will consult with the political parties, and (informally) with the chair of the board.

Transparency and accountability: The NZSF publishes an annual report, available online and in print form. It submits to national government monthly and quarterly reports on transactions and positions to a special purpose unit of the Ministry of Finance; the Crown Organisations Monitoring Unit receives reports from NZSF as well as other state-owned enterprises and financial institutions. The Unit has acquired the skills and expertise needed to make informed assessments of these reports for the Minister of Finance. The chair of the NZSF board meets with the relevant Parliamentary committee on an annual basis. Were significant issues to arise about its investments and operations it is expected that the Fund would inform the Minister in a timely manner.

Investment management: As noted above, NZSF is responsible for all aspects related to the management and investment of fund assets. Being a Crown owned organisation, it is nonetheless independent of the government civil service being able to hire and fire employees in a manner consistent with the finance industry. Nonetheless, there would appear to be implicit constraints on executive compensation, wherein salaries and bonuses are approved by the board but also reported to the Minister of Finance. In this respect, NZSF is not able to pay senior executive staff at quite the same levels as similarly situated staff across the Tasman. Even so, given its standing in the New Zealand finance industry, it has been able to attract highly qualified and experienced employees.

When established, it was expected that the fund would outsource most if not all its operations and investments. As such, NZSF has gone to the market to invest in commoditised products such as those offered by State Street of Boston. NZSF has also sought out smaller boutique investment companies, offering unusual opportunities consistent with its notional 25-year investment horizon. Being a relatively small fund, this strategy combined with the advantages of being a state owned enterprise has provided NZSF access to investments likely otherwise closed to such an organisation.

Over time, it has brought in-house investment functions where (a) NZSF has a critical mass of staff, (b) can take advantage of existing functions at marginal prices, and (c) can reap the advantages of being one of New Zealand's largest investment funds relative to local opportunities.

Crisis and response: while not as adversely affected by the global financial crisis as many other Western economies (notably in Europe and the USA), the newly elected National party government (2008) immediately faced a shortfall in revenue relative to expenditures. Rather than continue annual contributions to the fund by borrowing on the open market, the government halted contributions until at least 2014. At the same time, the fund reported returns of -4.9% (2008) and -22.1% (2009). Since then, returns for 2010 were 15.5%.

During the election campaign, the National party indicated that it would require the NZSF to invest as much as 40% of its assets in New Zealand. Upon government, the Minister of Finance directed the Guardians to seek "opportunities that would enable the Guardians to increase the allocation of New Zealand assets the Fund". This was justified by reference to Section 64 of the act establishing the fund where it is also noted that "the Minister must not give a direction that is inconsistent with the Guardians duty to invest the fund of improvement, commercial basis". In response, the chairman and chief executive officer of NZSF acknowledged the Minister's direction, noted that investment in New Zealand could incur costs of illiquidity and idiosyncratic risks, and noted that the Fund had already a significant stake in New Zealand. While they indicated that the Fund would seek relevant opportunities, it was also indicated that "we are unable to offer an assurance as to how much, if at all, the Fund’s New Zealand assets will increase."

Implications and conclusions: With the change of government and the global financial crisis, NZSF has sought to sustain its investment performance, recognising that further large contributions from government to its asset base is rather unlikely (in the near future). Given the size of the New Zealand economy, and the fact that many private financial institutions are owned by companies domiciled in other countries (notably Australia), the Fund looms large in public debate. Whereas the National party’s election manifesto challenged the independence of the Fund, it is arguable that the integrity of the enabling legislation sustained the Fund at a time of significant financial instability.

Having gained power and having dealt with the global financial crisis, the new government has come to realise that, should the Fund grow much larger (e.g., more than $50 billion), it could be a significant element for both the country's macroeconomic stability and its status in global financial markets. Whereas the mandate of the fund provides for the institution to manage its assets on a prudent basis with respect to risk and return, one lesson of the global financial crisis is that the government may have an interest in the risks borne by the Fund over the short term and the long term.