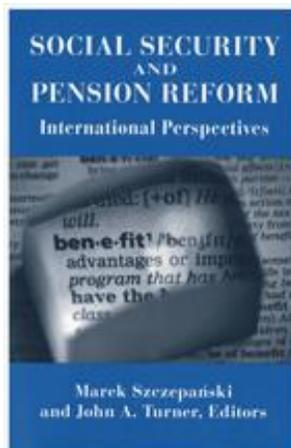

Upjohn Institute Press

Pension Fund Governance

Adam Samborski
Poznań School of Banking



Chapter 13 (pp. 287-298) in:

Social Security and Pension Reform: International Perspectives

Marek Szczepański and John A. Turner, eds.

Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2014

DOI: 10.17848/9780880994705.ch13

Social Security and Pension Reform

International Perspectives

Marek Szczepański
John A. Turner
Editors

2014

W.E. Upjohn Institute for Employment Research
Kalamazoo, Michigan

Library of Congress Cataloging-in-Publication Data

Social security and pension reform international perspectives / Marek Szczepanski, John A. Turner, editors.

pages cm

“This book is based largely on the 2012 conference of the European Network for Research on Supplementary Pensions (ENRSP), held at Poznan University of Technology, Poznan, Poland, on September 13-14, 2012”—Preface.

Includes index.

ISBN 978-0-88099-467-5 (pbk. : alk. paper) — ISBN 0-88099-467-3 (pbk. : alk. paper) — ISBN 978-0-88099-468-2 (hardcover : alk. paper) — ISBN 0-88099-468-1 (hardcover : alk. paper)

1. Social security. 2. Pensions. 3. Pensions—Government policy. I. Szczepanski, Marek, 1959- II. Turner, John A. (John Andrew), 1949 July 9-

HD7091.S5865 2014

331.25'22—dc23

2013043011

© 2014

W.E. Upjohn Institute for Employment Research
300 S. Westnedge Avenue
Kalamazoo, Michigan 49007-4686

The facts presented in this study and the observations and viewpoints expressed are the sole responsibility of the authors. They do not necessarily represent positions of the W.E. Upjohn Institute for Employment Research.

Cover design by Alcorn Publication Design.
Index prepared by Diane Worden.
Printed in the United States of America.
Printed on recycled paper.

13

Pension Fund Governance

Adam Samborski
Poznań School of Banking

This chapter analyzes the formal institutions of corporate governance for pension plans. It applies this analysis to open pension funds, which are mandatory individual account plans, operating in Poland. Each pension fund has a specific institutional arrangement, which determines to a large extent its effectiveness. Such an arrangement sets the pension fund under the influence of many stakeholders. The primary objective of regulations in the governance area of pension funds becomes a minimization of potential agency problems—conflicts of interest that may arise between the pension participants and those responsible for the fund’s management.

PRINCIPAL–AGENT PROBLEM

In agency theory, agency relationships are understood as contracts under which a principal engages a third party (agent) to perform certain actions on their behalf in dealing with a second party, which is the provider of the service. The essence of agency theory can be reduced to two basic assumptions. First, expectations and objectives of principal and agent are various and remain in conflict (difference of interests, different objective function). Second, it is very difficult and expensive for the principal to check the agent’s work. In agency theory the basic concept is the agency relationships (Szczepański 2010).

In pension arrangements, the plan participant is the principal, the plan sponsor is the agent, and the financial institution managing the pension funds is the second party. This implies the need for the principal to delegate certain powers to the agent to make certain decisions.

Then an agency relationship arises, which can be a public contract (formal, explicit) or an implicit contract (informal). The purpose of the contract is to ensure such actions of the agent so that he/she strives to maximize the principal's benefits. However, between the agent and the principal there is an asymmetry of information. This can lead to the agency problem, which usually occurs in two situations: hidden action of the agent, and hidden information or hidden knowledge possessed by the agent (Mesjasz 2002). In the first situation, the agent takes action, the course or outcome of which cannot be observed by the principal, resulting in the risk of moral hazard (the inclination of someone who is imperfectly checked to take part in behavior which may be dishonest or undesirable). In the second situation, the agent has information about environment variables, which the principal does not have before or after the conclusion of the contract. Ex ante asymmetry can lead to adverse selection, with the party having the superior information benefiting at the expense of the party with inferior information (Mesjasz 2002).

Agency problems can be prevented by concluding a complete contract, which will take into account all possible aspects and options of future situations. However, drawing up a complete contract is not feasible. Thus, we are dealing with incomplete contracts between principals and agents (Mesjasz 2002).

Agency problems can be limited in three ways:

- 1) reduction of information asymmetry,
- 2) seek harmonization between the principal's and the agent's objectives, and
- 3) building trust.

There are two options for reducing information asymmetry: screening (the principal keeps track of the agent in the corporation) and signaling (the agent gives specific signals to the principal, such as reports). Second, the interests of the principal and the agent can be harmonized by introducing incentive schemes (such as managerial options). Third, the agency problem can be reduced by agents building reputational capital that they want to maintain (Brink 2007).

Shaping the behavior of the agent in such a direction that his or her actions diverge from the principal interest as little as possible requires incurring certain costs, including drawing up contracts, monitoring and controlling the conduct of the agent by the principal, ensuring the interests of the principal, and residual loss (Aluchna 2002).

AGENCY PROBLEMS IN PRIVATE PENSION FUNDS AND WAYS TO LIMIT IT

Three levels of retirement provision can be distinguished under pension plans. The first two are mandatory and consist of redistributive and saving parts. The third, however, is voluntary: individual or occupational. The first level, redistributive, includes programs to ensure the minimum subsistence level for pensioners. The second level, savings, is designed to provide pensioners with a target retirement standard of living comparable to that when they were economically active. Within these levels, the programs are further classified by source (public, private), or the way to determine the pension benefits (Samborski 2011).

The following discussion addresses the second level—more precisely, private pension plans and funds—and the third level of pension provision. (The discussion does not apply to pension plans financed using book reserves, as in Germany.)

Assuming that the pension fund, like any organization, is a nexus of contracts, one can identify different expectations of pension funds stakeholders, but also areas of potential conflicts (Hess and Impavido 2004). Pension fund governance is, therefore, a mirror image of corporate governance in joint stock companies, which consists of a set of relations between the company's management, supervisory board, shareholders, and other stakeholders (OECD 2002). Pension fund governance, as well as corporate governance, deals with the posting of property rights by the principal to the agent, and consequently relies on the professional skills and management effectiveness of the agent (World Bank 2007). Private pension plans operate on the basis of the agency relationship between the plan members and beneficiaries, and the persons or entities involved in administering or funding it (such as a plan administrator or a plan sponsor). Governance under such plans includes all of the relationships between the entities and persons involved in the operation of a retirement plan, and it provides the structure through which the objectives of the retirement plan are established and the means to meet those objectives (OECD 2002).

Pension fund governance deals with issues of pension fund control and seeks to answer two basic questions: 1) in whose interests should checks on pension funds be carried out, and 2) who should monitor

and control the pension funds on behalf of their members? The basic principles of corporate governance are applicable here: transparency, accountability, fairness, and responsibility (World Bank 2007).

Nonetheless, pension fund governance is much more complex than corporate governance because of the larger number of parties directly involved in pension fund operations. Therefore, all the rules of corporate governance do not apply here. Pension fund members do not generally exercise control through voting on fund administration, asset management companies, and their employees. It is difficult for fund members to dismiss a body managing the fund if it fulfills its duties improperly. In such cases the only solution for fund members is to change the fund or make claims for damages (World Bank 2007).

Governance in private pension plans and funds includes managerial control of the organization and means of regulation, including liability of management, and how it is monitored. The primary objective of regulation in pension funds governance is to reduce the potential agency problems or conflicts of interest that may arise between fund members and those responsible for managing the fund, which could negatively affect the security of retirement savings (Stewart and Yermo 2008). From this perspective, pension fund governance comes down to two issues: to protect the rights and interests of pension funds members, and to ensure the safety of sources of funding for future retirement benefits (World Bank 2007). It is worth considering, however, whether pension fund governance should be limited to minimizing the agency problems occurring between pension fund members and the entity responsible for managing the fund.

The pension fund can be considered as a nexus or network of explicit and implicit contracts between all entities in the relationship with it. Hence, pension fund governance cannot be confined only to deal with agency problems; its aim should be understood broadly to ensure good performance of the pension fund while maintaining low costs for all stakeholders (Stewart and Yermo 2008). Good governance, therefore, should be correlated with high rates of return on investment and low cost of capital (World Bank 2007).

Good governance of pension funds has a lot of benefits, which include building trust between all stakeholders, and reducing the need for specific regulations or facilitating supervision. It is also conducive to improving the efficiency of corporate governance in portfolio compa-

nies. The better managed the pension fund, the greater the opportunity to multiply the value of investments through the policy of active shareholders. Good governance in the pension fund must take into account the risk. The more sophisticated the investment strategies, the stricter and stronger the pension plan supervision must be (Stewart and Yermo 2008). The basis of pension fund operations should be, therefore, trust and development of long-term relationships with all stakeholders.

In pursuing these objectives, it is worth looking at the Guidelines for Pension Fund Governance elaborated by the OECD. The guidelines contained in them may be useful in the implementation of strategies for building trust and developing long-term relationships with all stakeholders. These guidelines are divided into two groups: governance structure and governance mechanisms.

Governance structure should provide the appropriate division of operational and supervisory responsibilities, and define the responsibilities and abilities of those entrusted to pension fund responsibilities (OECD 2002). Thus, it includes the following eight points:

- 1) Identification of responsibilities. There should be a clear identification and separation of operational and oversight responsibilities in the governance of a pension fund.
- 2) Governing body. Every pension fund should have a governing body vested with the power to administer the pension fund and which is ultimately responsible for ensuring the adherence to the terms of the arrangement and the protection of the best interest of plan members and beneficiaries.
- 3) Accountability. The governing body should be accountable to the pension plan members and beneficiaries, its supervisory board (where relevant), and the competent authorities.
- 4) Suitability. Membership in the governing body should be subject to minimum suitability (or nonsuitability) standards in order to ensure a high level of integrity, competence, experience, and professionalism in the governance of the pension fund.
- 5) Delegation and expert advice. The governing body may rely on the support of subcommittees and may delegate functions to internal staff of the pension entity or external service providers.

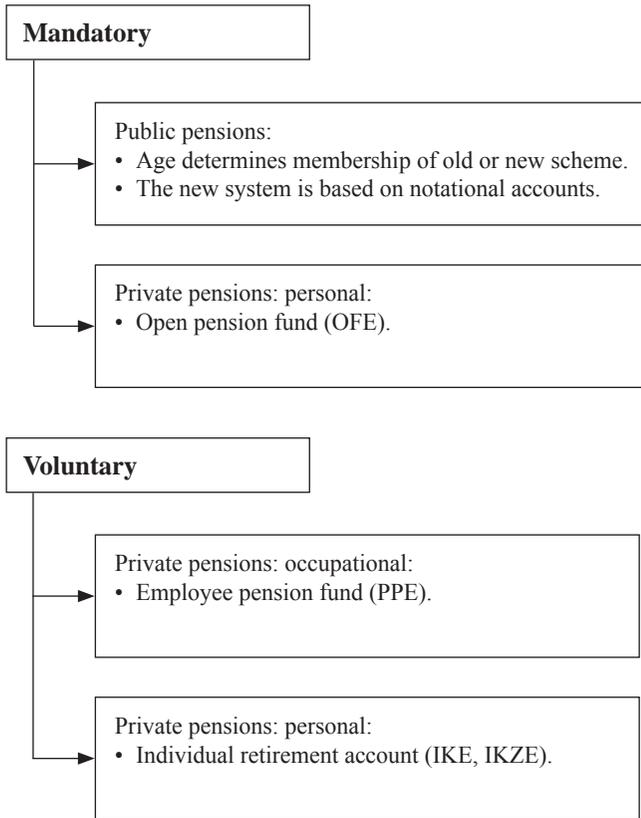
- 6) Auditor. An auditor, independent of the pension entity, the governing body, and the plan sponsor, should be appointed by the appropriate body or authority to carry out a periodic audit consistent with the needs of the arrangement.
- 7) Actuary. An actuary should be appointed by the appropriate body or authority for all defined benefit plans financed via pension funds.
- 8) Custodian. Custody of the pension fund assets may be carried out by the pension entity, the financial institution that manages the pension fund, or by an independent custodian (OECD 2009).

Pension funds should have appropriate control mechanisms, communication, and incentives to encourage good decision making, proper and timely implementation, and regular reviews and assessments (OECD 2002). The mechanisms of governance include the following:

- Risk-based internal controls. There should be adequate internal controls in place to ensure that all persons and entities with operational and oversight responsibilities act in accordance with the objectives set out in the pension entity's bylaws, statutes, contract, or trust instrument, or in documents associated with any of these, and that they comply with the law.
- Reporting. Reporting channels between all the persons and entities involved in the governance of the pension fund should be established in order to ensure the effective and timely transmission of relevant and accurate information.
- Disclosure. The governing body should disclose relevant information to all parties involved (notably pension plan members and beneficiaries, plan sponsors, supervisory authorities, and auditors,) in a clear, accurate, and timely fashion (OECD 2009).

ADDRESSING THE AGENCY PROBLEM IN PENSION FUNDS IN LIGHT OF POLISH EXPERIENCE

This analysis of governance solutions in pension funds in Poland is limited to open pension funds (see Figure 13.1), which are manda-

Figure 13.1 Structure of the Pension System in Poland

SOURCE: IOPS (2009).

tory individual account pension plans. Through the pension funds, part of the employee's earnings (collected by the Social Insurance Institution—it also manages the public pension plan) is invested in individual accounts. These accounts are managed by one of several funds. Employees buy from their fund a retirement annuity, which, when they retire, will serve as a source of retirement income. The amount of annuity depends on the amount of cash accumulated during one's career and the effectiveness of their investment.

Open pension funds can be created only by a general pension society (hereafter Society) acting as a joint stock company. The dominant shareholders of general pension societies are financial institutions, including international insurance companies, Polish financial institutions, and various consortia of Polish and international financial institutions (Kerner and Reinhardt 2010). The duration of the fund is unlimited. The fund acquires a legal personality upon being entered in the register of funds, then the fund authority becomes the Society. The basic document governing the internal affairs prevailing in the fund is the Articles of Association.

The objectives of the company are solely devoted to the creation and management of funds and their representation to third parties. The general society creates and manages (for a fee) only one open fund. The share capital of the company cannot be raised by public subscription. A purchase or acquisition of company's shares requires an approval of a supervisory authority, which is the Financial Supervision Commission.

The governing bodies of the Society are the Management Board, the Supervisory Board, and the general meeting. The Management Board of the Society cannot have fewer than three members, and it may also have an audit committee. Unless the Articles of Association provide otherwise, the general society board members are appointed and dismissed by the general meeting. The member of the Management Board must be a person who meets the following requirements:

- has full legal capacity;
- has not been convicted of an offense against property, credibility of documents, business transactions, trading in money and securities, tax offense;
- has higher education;
- holds a work experience of no less than seven years; and
- gives guarantee of the due performance as the board member.

At least one-third of the board should hold a university degree in law, economics, or be included in the list of investment advisors.

The Supervisory Board member of the Society must be a person who meets the requirements for the management board members in the first two points and gives guarantee of due performance as a member of the Supervisory Board. At least half of the Society Supervisory Board

members should have a degree in law or economics. Moreover, at least half of the members of the general pension society are appointed from outside of shareholders of the Society and other related entities. The Society is responsible to the members of the fund for any damage caused by failure to perform or improper performance of their duties in managing the fund and its representation. The membership of the open fund follows the conclusion of the contract with the fund (Act of 28 August 1997).

The pension society receives from the pension fund a fee levied in the form of a percentage deduction from the amount of premiums (contributions) paid, not more than 3.5 percent, except that the deduction is made before the conversion of contributions into accounting units. In addition, the pension society charges a fee at the rate specified in the Articles of Association. This rate cannot exceed the amount calculated according to the scale specified by law. The rates of management fees decrease with each increase in fund assets exceeding the successive assets thresholds by the fund. Costs related to transactions of purchase or sale of fund assets and costs associated with the storage of assets by the depositary are covered by the fund assets. In addition, pension societies incur a fee for the contributions transfer and the costs of supervision and the Insurance Ombudsman. There is also the cost of the guarantee fund that insures the pension funds (Soldek 2011).

The pension fund invests its assets in accordance with the law, seeking to achieve a maximum degree of safety and profitability of the investments made. The legislature defines the investment limits.

The open fund, which has received contributions for at least 36 months, determines each year at the end of March and September the rate of return for the last 36 months and reports it to the supervisory body. On this basis, the supervisory body calculates the weighted average rate of return of all open-end funds and releases that information to the public. The weighted average rate of return is the basis for calculating the minimum required rate of return that applies for all open pension funds. When the rate of return of an open pension fund for the period of 36 months is smaller than the minimum required rate of return, a deficit arises in an open fund, which sponsors of the open fund will pay.

The fund is obliged to choose a depositary, to whom, by an agreement, it entrusts the storage of its assets. A depositary can only be a

bank. The agreement with the depositary for the fund assets storage should specify in detail the duties of a depositary and the fund.

The open fund is obliged to publish a prospectus once a year in a national daily newspaper dedicated to the fund announcements and advertising. The fund's prospectus should contain its Articles of Association, information on the fund's investment performance, and approved annual financial statements of the fund. The Society and the fund provide periodic reports to the supervisory authority and current information on their activities and financial position (Act of 28 August 1997).

CONCLUSION

The basic sources of conflicts of interest in the pension funds occur in the relationships between fund members and the management entity on the amount of fees charged by the Society.

The pension fund is a legal entity. The managing body of the fund is the pension society established as a joint stock company. Such a solution entails reducing the efficiency of the management authority focused on the best interests of pension plan members. Pension funds have been established in the majority of cases by the general pension societies in which dominant shareholders are financial institutions. As a result, financial institutions easily introduce their candidates to the supervisory boards of societies. It may turn out that the financial institution controls both the Supervisory Board and the Management Board. Therefore, it is proposed to take steps aimed at increasing the independence of supervisory boards in general pension societies.

Furthermore, the low level of society's economic awareness and the low interest in retirement issues encourage societies to undertake expensive marketing campaigns to attract as many members as possible. Such campaigns usually lead not to improved investment performance of the fund but to higher administrative costs and fees incurred by fund members. Hence, I propose a statutory reduction of fees that pension societies charge, and linking their pay to the results of open pension funds investment. In addition, greater emphasis should be laid on finan-

cial education relating to the pension system operating principles in the Polish society.

A wider analysis of detailed internal regulations in the area of governance would be advisable, both in open pension funds and in general pension societies. The problem, however, is that such legal solutions have not been made public. This remark does not apply to principles of corporate governance in investment operations of open funds and their Articles of Association, which are publicly available. To explain the reasons for varying the rate of development of individual pension funds, the institutional analysis should be applied not only to formal institutions of corporate governance, but also informal institutions. The results of such analyses would allow for studying the issue of improving the efficiency of Polish pension funds investment from a different perspective.

References

- Act of 28 August 1997. Law on the Organization and Operation of Pension Funds. Based on Journal of Laws of 2010, No. 34, Item 189, with subsequent amendments.
- Aluchna, Maria. 2002. "Koszty agencji jako determinanta efektywności nadzoru korporacyjnego." In *Strategiczne obszary nadzoru korporacyjnego zewnętrznego i wewnętrznego*, Stanisław Rudolf, ed. Łódź, Poland: University of Łódź, pp. 75–85.
- Brink, Alexander. 2007. "A Normative Theory of the Firm. Specific Investments as Legitimation for Residual Claims: Considerations on Ethical Integration from the Perspective of Governance Theory." Paper presented at the Conference of the German Association of Economists, held at the University of Freiburg, March 1–3. <http://www.wipo.uni-freiburg.de/conferences/vfs-tagung> (accessed August 26, 2013).
- Hess, David, and Gregorio Impavido. 2004. "Governance of Public Pension Funds: Lessons from Corporate Governance and International Evidence." In *Public Pension Fund Management. Governance, Accountability and Investment Policies*, Alberto R. Musalem and Robert J. Palacios, eds. Washington, DC: World Bank, pp. 49–90.
- International Organization of Pension Supervisors (IOPS). 2009. *Country Profiles—Poland*. Paris: IOPS. <http://www.oecd.org/site/iops/research/44873983.pdf> (accessed September 30, 2012).
- Kerner, Andrew, and Eric Reinhardt. 2010. *Wpływ polityki inwestycyjnej OFE*

- na ład korporacyjny w Polsce*. Sprawne państwo. Warsaw: Ernst & Young Polska Sp. z o.o.
- Mesjasz, Czesław. 2002. "Kontrakty niekompletne jako podstawa teoretyczna nadzoru korporacyjnego." In *Strategiczne obszary nadzoru korporacyjnego zewnętrznego i wewnętrznego*, Stanisław Rudolf, ed. Łódź, Poland: University of Łódź, pp. 53–66.
- Organisation for Economic Co-operation and Development (OECD). 2002. *Guidelines for Pension Fund Governance*. Paris: OECD. <http://www.oecd.org/insurance/privatepensions/2767694.pdf> (accessed September 30, 2012).
- . 2009. *OECD Guidelines for Pension Fund Governance*. Paris: OECD. <http://www.oecd.org/insurance/privatepensions/34799965.pdf> (accessed September 30, 2012).
- Samborski, Adam. 2011. "Determinanty zmian w systemach emerytalnych – ujęcie globalne." *Polityka Społeczna*. Numer specjalny: Problemy zabezpieczenia emerytalnego w Polsce i na świecie. Część I: pp. 31–35.
- Soldek, Andrzej. 2011. "Wpływ opłat na wielkość oszczędności gromadzonych w regulowanych i dobrowolnych systemach emerytalnych." *Polityka Społeczna*. Numer specjalny: Problemy zabezpieczenia emerytalnego w Polsce i na świecie. Część I: pp. 38 – 43.
- Stewart, Fiona, and Juan Yermo. 2008. "Pension Fund Governance: Challenges and Potential Solutions." OECD Working Papers on Insurance and Private Pensions. No. 18. Paris: OECD. doi:10.1787/24140225631 (accessed August 26, 2013).
- Szczepański, Marek. 2010. *Stymulatory i bariery rozwoju zakładowych systemów emerytalnych na przykładzie Polski*. Poznań: Wydawnictwo Politechniki Poznańskiej.
- World Bank. 2007. *Czech Republic. Pilot Diagnostic Review of Governance of the Private Pension Fund Sector*. Washington, DC: World Bank.