



Do Beneficiaries Know What They Want ?

Pension schemes governance and the very long run



- 1. Why is the contract between ultimate beneficiaries and ultimate managers of a pension fund so incomplete ? Information asymetries, heterogeneity of preferences and investment principles legitimacy.**
- 2. What does it mean to be a long term investor and how to implement a long term strategy along the whole investment chain? The case study of the Fonds de Réserve pour les Retraites.**

1. Why is the contract so incomplete?

- ▶ **Pension fund staff absolutely need guidance from beneficiaries or their representatives :**
 - **For technical reasons : « optimal » investment policy relies on investor's characteristics : investment horizon and liabilities profile, risk aversion, SRI preferences... Pension fund officers need to know the « utility function » of people they're working for.**
 - **To get legitimacy towards risk : Staff may bring their skills and knowledge of good practices from the industry... Yet they have no legitimacy to take risk on behalf of third people. Most of « good opportunities » will not be reaped unless owners of ultimate benefits would explicitly endorse the corresponding risk.**
 - **To understand their investment values - including SRI values - and to make sure ultimate managers will integrate them.**

1. Why is the contract so incomplete ?

- ▶ **But most beneficiaries are far from being able to formalize what they want, if only they knew what they need :**
 - **Their objective is quite simple to summarize: broadly speaking, they want the same economic conditions for their own pension as older generations enjoyed before them.**
 - **Yet, most people are not aware of the true gap in their pension systems ... and underestimate the risk not to reach their – implicit- targeted replacement rate (See Boeri and alii., 2001 & 2002).**
 - **In addition, they are not equipped to set out clearly their own preferences between return and risk...**
 - **While facing a complex financial environment, made even more complex by the daily noise produced by market professionals ...**

1. Why is the contract so incomplete ?

- ▶ **So pension funds governance bodies are in a very complex situation where they should simultaneously produce different kind of output:**
 - **They should be able to express heterogenous, implicit or even unknown preferences of ultimate beneficiaries in an aggregate, explicit and practical way to be used for the definition of a long term investment strategy fit to the Fund's characteristics;**
 - **They should decide this strategy, based both on technical expertise and the legitimacy they should get from their relationship with beneficiaries;**
 - **They should implement this strategy in a consistent way with Fund's characteristics, its investment principles and values, selecting and monitoring asset managers accordingly.**

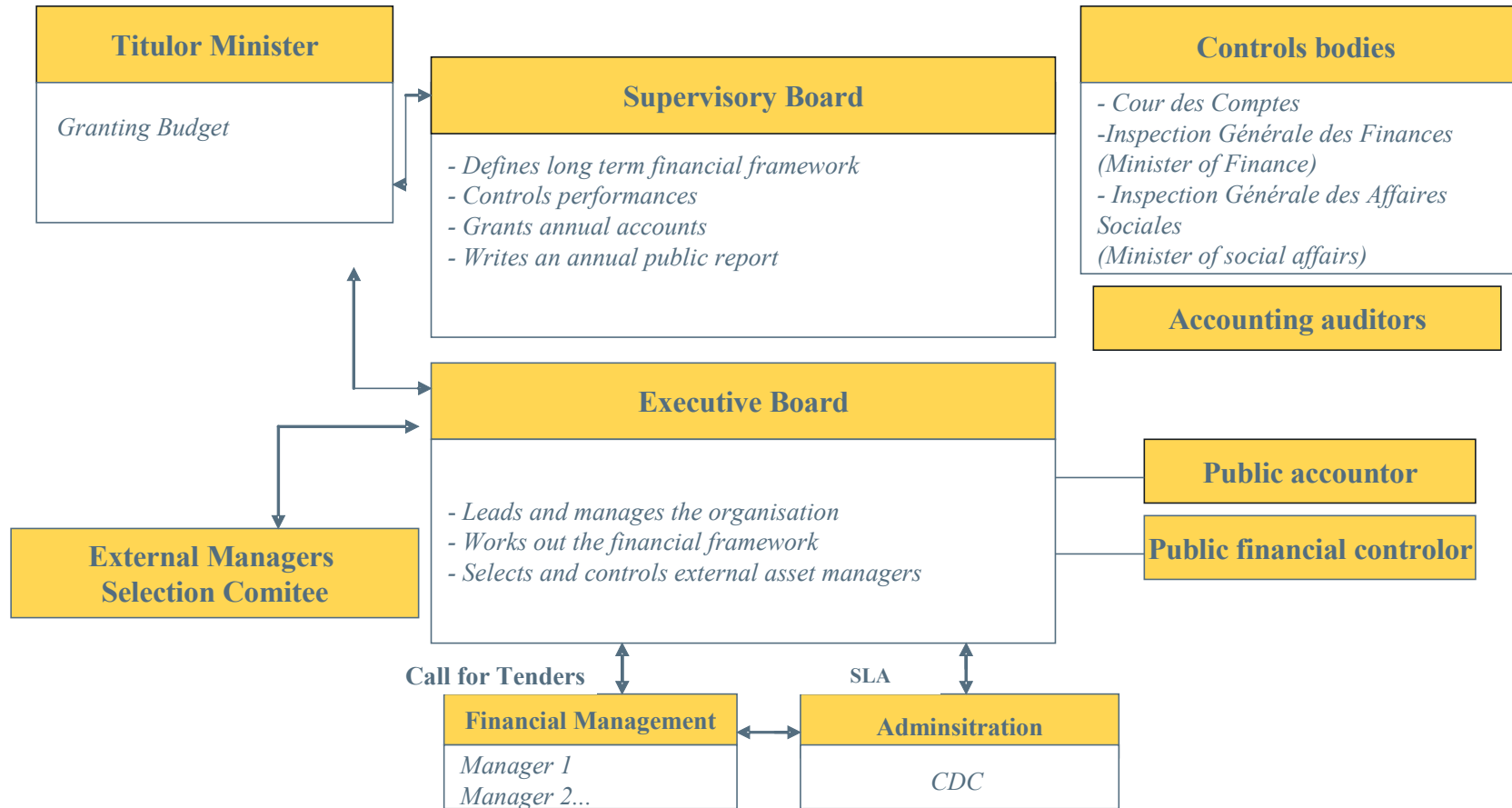
2. In practice? The case study of a long term «macro» fund

- ▶ **With respect to these issues, FRR appears in a very extreme situation :**
 - **FRR is a nation-wide scheme, covering almost all the private sector workers;**
 - **Its investment horizon is very long, since no liabilities have to be paid before 2020. Yet, the precise amount of liabilities it will have to cover has not been precisely defined by the law;**
 - **It is funded mainly through government receipts (and not workers contributions) and will not serve pensions in the future, but lump-sum transfers to the First pillar general PAYG scheme;**
 - **It is forbidden by law to manage its assets internally; thus the implementation of its long term strategy relies almost entirely on external investment managers.**

2. In practice? The case study of a long term «macro» fund

- ▶ **Governance structure has been defined in order to clearly separate strategic decisions from day-to-day management:**
 - **A supervisory board (SB) of 20 members, mainly social partners representatives experienced with pension issues;**
 - **An executive board (EB) in charge of short term (tactical) allocation, managers selection and day-to-day management;**
 - **An asset managers selection committee, composed of former investment professionals, assisting the executive board in managers selection and performance analysis;**
 - **A technical staff, preparing the boards' decision and the committee's meetings, and monitoring external managers;**
 - **Around 30 external specialized asset managers, selected through competitive call for tenders, responsible for securities selection.**

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- ▶ **A decision-making process aiming at reducing agency issues:**
 - **Risk and return objectives are expressed by SB on the basis of an objective criteria, consistent with the Fund's characteristics;**
 - **Strategic asset allocation is decided by SB, on the basis of technical proposals from EB and Fund's staff :**
 - **Technical assumptions and optimization methods are transparent, corrected from « optimist » biases, and explained as clearly as possible to be sure they are fully understood and endorsed by SB members;**
 - **Analysis and discussions between SB and EB only stick to Fund's investment profile and needs.**

2. In practice? The case study of a long term «macro» fund

- ▶ **Decentralized implementation through external asset managers is complex, but seeks to be done accordingly with the grounds of the long term investment strategy:**
 - **A clear separation of missions between FRR internal staff and external asset managers to minimize conflict of interest;**
 - **Selection and Monitoring processes are designed to favour management styles and strategies consistent with FRR's investment philosophy and values.**

- ▶ **Little doubt that beneficiaries do not know what they want in terms of financial strategy : They often do not know what they need to prepare their future pension and most of them are not equipped to face a complex financial environment;**
- ▶ **Beneficiaries can delegate to Trustees or members of a supervisory board the mission to define the most efficient strategy on their behalf. This raises agency problems, which could even be increased in a case of decentralized implementation through external asset managers;**
- ▶ **All these difficulties could however be alleviated provided that adequate organization and processes are put in place, seeking a good balance between expertise and legitimacy;**
- ▶ **It looks like a very hard challenge, but it's worth being tried: Collective pension scheme could then allow low-income households, with poor financial literacy, to access quite sophisticated investment strategies, fit to the « true » horizon of their pensions and life expectancy.**