Pension Funds Foreign Investment: How to handle the risk

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Pension fund investment regulation

- Quantitative Asset Restrictions (QAR) is where government makes specific regulation regarding investment in specific asset classes

- Prudent person Rule (PPR) where pension funds are invested by managers or trustees "prudently" or more generally, as someone would do in managing their own assets. There is usually no strict restriction on any particular type of asset

- The two approaches are extremes on a continuum with many countries somewhere in between

Quantitative Asset Restrictions (QAR)

- While many countries still impose some form of QAR, the general trend globally is to relax QAR

- The pace of liberalization slowed immediately after the global financial crisis but the trend to liberalization has continued

- QAR are generally designed to prevent or restrict extreme investment decisions and usually have an objective of setting some minimum level of diversification

- Typical QAR set maximum levels with asset classes but some set minimums

Dangers and risks of QAR

- Minimum investment levels (floors) are probably worse than maximum
- QAR that limit diversification either among asset categories or by geographic restrictions should be avoided
- QAR tend to lag behind market developments
- QAR do not give sufficient attention to the overall amount of risk in the fund's investment portfolio

Prudent Person rule (PPR)

- More flexible to market changes
- Focus shifts to behavior rather than meeting pre determined outcomes
- PPR requires a different kind of supervisory response with a qualitative rather than a quantitative focus

International Investment by Pension Funds

Two important questions:

- Do international investment restrictions reduce risk to the fund?

- Do international investment restrictions stabilize the domestic economy or develop the local capital market?

Do International investment restrictions reduce risk?

- Restrictions on international assets tend to be related to portfolios with a high proportion of domestic bonds and assets leading to a focus on risk at the individual asset level rather than at the portfolio level. Conservative asset allocation will likely lead to poor long term returns.

- Restrictions can encourage national governments to treat pension funds as a mechanism to fund budgetary requirements. By forcing high holdings of government bonds, governments may have an incentive to create inflation to reduce their debt burden. Further, if the government repays the bonds in the future from tax revenue, is the outcome much different from a pay as you go pension scheme?

Evaluating international diversification

- International investing will increase the impact of currency movements on pension funds' total portfolio returns so fund will need an appropriate currency policy

- Managing currency risk by hedging is commonplace

- The central investment covenant is that fund mangers and/or trustees need an investment strategy for each investment option and this strategy should be properly documented

What should supervisors do?

- Understand what the fund is trying to do with each investment
- Ensure that the fund understands the risks associated with the investment eg international tax law, valuations, liquidity
- Ask fund to explain how it intends to achieve its stated investment objectives
- Ensure there is a process in place for monitoring investments and investment managers and for monitoring performance against objectives