SSNIT INVESTMENTS SERIES

TENTH EDITION

INTRODUCTION

The Social Security and National Insurance Trust (SSNIT) must prudently invest accumulated cash reserves to gain maximum returns to support benefits payment and also meet the cost of administering the Scheme. Investment returns ensure the financial stability and sustainability of the Scheme in honouring current and future liabilities. This is achieved through prudent investment selection, management and monitoring by the Investment & Development Division (IDD) and partly by the Finance Division through the Treasury Department. In fulfilling this mandate, all investment activities are guided by internationally accepted guidelines for investing social security funds, which are issued by the International Social Security Association (ISSA), of which SSNIT is a member; as well as guidelines issued by our regulator, the National Pensions Regulatory Authority (NPRA) and Policy Guidelines from the SSNIT Board of Trustees.

In this edition of the SSNIT Investments Series, we will introduce the ISSA guidelines on investment of social security funds and cover the guidelines relevant to the SSNIT Scheme in the next edition. In subsequent editions, we will cover the guidelines issued by the NPRA and the SSNIT Board of Trustees.

OVERVIEW OF THE ISSA GUIDELINES ON INVESTMENT OF SOCIAL SECURITY FUNDS

The ISSA Guidelines on Investment of Social Security Funds allow members to follow a progressive framework of governance by setting up various structures, which include defining roles and how these roles interact to ensure that the pension fund objectives are met. The governance process includes defining and monitoring an investment strategy with a set of guidelines, monitoring performance and reporting. The guidelines also recognize that some social security institutions carry out investment management internally while others use external managers. Hence, the investment governance processes are addressed in three discrete sections:

- Common governance processes (relevant for social security institutions which carry out Investment management internally and/or externally);
- Governance processes specifically relevant for only internal investment units;
- Governance processes specifically relevant for only external investment managers.

SSNIT's investments are managed internally and therefore, we will concentrate on those guidelines in the next edition of the Investments Series to be issued.

In institutional investment, "governance" describes a system of decision-making and oversight used to invest the assets of a fund. The responsibility for this role lies with fiduciaries (trustees) such as the board and management of social security organizations. The fiduciaries are faced with high-level issues and therefore, delegate detailed implementation actions to others and the fiduciaries' role becomes monitoring of those actions. Investment governance, in short, employs skills, resources and processes to create value for the social security institution.

The challenge of governance in social security administration is greater than dealing with the generic issues that affect all modern organizations. Social security institutions operate in global/domestic financial markets, where the management of risk and uncertainty is crucial to the creation of long-term value. Governance can create or destroy value without the establishment of clearly defined objectives. Risk-taking against well-defined objectives is therefore, an essential ingredient in any well-governed financial institution.

The ISSA guidelines cover all aspects related to the progressive process of governance to be taken by an institution. However, there are four stages that are key to the investment process itself. These four stages, briefly summarized herein, relate to decisions regarding the investment strategy, building up an appropriate portfolio based on this strategy, implementation of the strategy, and monitoring and reporting of the process.

1. Investment strategy

As a general principle, the strategic asset allocation of an investor accounts for the majority of returns the investor gets. Therefore, it is an essential part of the investment process. Strategic asset allocation involves setting target allocations for various asset classes and rebalancing periodically to maintain these original targets. The strategic asset allocation is long term in nature and reflects the social security institution's investment beliefs, investment mission and goals, return objectives, liabilities and funding policy, risk tolerance, and the extent to which these may be impacted upon or constrained by non-financial factors.

Risk tolerance includes consideration of the likely correlation between the financial well-being of the ultimate sponsor (the government/taxpayer) and the events that may cause a downturn in the assets of the social security institution. In addition to constructing a strategic asset allocation, a review of investment strategy typically includes asset-liability modelling (where the liabilities may be inflation linked, for example), stress tests on key areas of risk to identify the main risk exposures, reflections on diversification and hedging of selected risks.

2. Portfolio Construction

Portfolio construction is the first step in the implementation of an investing institution's strategic asset allocation. The objective of portfolio construction is to efficiently translate the goals of the strategic asset allocation into investment decisions. This process includes considering the investment mission, investment beliefs, return target and corresponding risk, available investment choices and liquidity requirements. The portfolio has to be sufficiently diversified using frameworks such as asset class, geographic region, domestic sector classification, risk premia and possibly thematic investments.

Additionally, the portfolio has to be constructed using the most efficient investment possibilities available to achieve the desired return and risk objectives. The portfolio construction has to be dynamic by revisiting the asset allocation in light of changing market conditions. Clearly defined and shared investment beliefs, or working assumptions about the way the investment world functions would improve the efficiency of decision making for portfolio construction.

3. Implementation

Implementation involves applying the investment decisions made in portfolio construction by selecting specific investments. The investing institution considers its expertise and governance capability when choosing whether to manage assets through an internal investment unit, or through the appointment of external fund managers, or in collaboration with an external investment adviser. For institutions that use external fund managers the guidelines state that the institution must have the resources and expertise required to adequately research, select and monitor "best-in-class" managers or appoint an external investment adviser who has the capability to do so.

Implementation also emphasises selecting investments with maximum efficiency. This includes evaluating the value versus cost for each investment selected when constructing a portfolio. Value reflects the degree to which the investment objective is achieved. Cost is often represented by investment manager's fees (where applicable), which may be a significant drag on gross investment income. Custody arrangements and the transitioning of assets are also key considerations when implementing an investment strategy.

4. Monitoring and reporting

Regular measurement and monitoring of key investment activities and risks are essential to help the investing institution make timely and informed decisions, and ultimately, achieve efficient management of its assets. The board and management must analyse key metrics available to them, such as the overall asset distribution relative to strategic allocations, and the performance and risk of the overall portfolio and its underlying managers, as well as qualitative reviews of external fund managers (where applicable), global/domestic markets and macroeconomic dynamics. The investing institution's ability to manage investment strategy dynamically depends upon its having a robust method for monitoring progress against the long-term strategy and the level of risk inherent in the portfolio. While investment strategy is typically set for the long term, there are times when dynamic or tactical allocations are made to reflect current market opportunities or threats.

The Guidelines

In total, there are thirty-three guidelines grouped under four sections. Out of the thirty-three, seventeen are relevant to the SSNIT Scheme as it has an internal investment management unit. The relevant guidelines will be discussed in our next issue of the SSNIT Investments Series.

The ISSA guidelines on investment of social security funds require that, the investment activities of the board, management, investment unit and other representatives of the social security institution respect ISSA's five principles of good governance; namely, Accountability, Transparency, Predictability, Participation and Dynamism.

<u>Accountability</u> is the ability to hold legally responsible the officials who are in charge of the institution. It requires establishing norms and standards to evaluate the achievement of the institution's mission, and a well-functioning system of redress that protects the interests of stakeholders and deters mismanagement and deviations from the institution's mandate. As trustees, social security administrators are responsible, and hence accountable, for managing the social security programme prudently, efficiently and equitably.

<u>Transparency</u> is the availability and accessibility of accurate, essential and timely information to ensure that stakeholders are well informed of the true state of the social security programme and how it is being managed. Transparency in the decision-making process promotes honesty, integrity and competence, and discourages wrongdoing. Clarity and simplicity of rules, systems and processes help to limit the areas that would require discretion and arbitrariness in programme administration.

<u>Predictability</u> refers to the consistent application of the law and its supporting policies, rules and regulations. For social security programmes, the rights and duties of members and beneficiaries must be well defined, protected and consistently enforced. Surprises and sudden changes in contribution rates, benefit entitlements or other features may seriously undermine the credibility of the programme.

<u>Participation</u> refers to the active education, engagement and effective involvement of stakeholders to ensure the protection of their interests. The meaningful participation of stakeholders depends on their access to information about the institution and their capacity to understand and act on such information.

<u>Dynamism</u> is simply defined as the element of positive change in governance. While the other four principles of governance may well be applied in the context of maintaining a status quo, dynamism refers to changing and improving on the status quo itself, by doing things more efficiently and equitably, and by responding to the evolving needs of programme members and beneficiaries, thereby creating new value.

Stay tuned for our next issue!