

INVESTMENT OF SOCIAL SECURITY FUNDS: THE PHILIPPINE EXPERIENCE

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INTRODUCTION

Thank you for inviting me to this gathering. It is my honor to address the esteemed members of the Board of the Asean Social Security Association (ASSA) and their guests on a topic that has, as of late, become a concern among social security administrators all over the world- that is the "*Investment of Social Security Funds*". Today's meeting actually gave me an excellent opportunity to gather my thoughts on this aspect of social security administration, based on the experiences and learnings that I have been fortunate to have from my association with the country's biggest pension systems, the GSIS and the SSS.

Until recently, *Investments of Social Security Funds* as a topic for seminars such as this has not been given as much attention as other issues relating to the aspects of administering social security institutions such as funding, coverage and benefits administration. To my mind, there are several reasons for the shift of interest on the investment operations of pension systems:

1. Pension funds over the years have grown substantially in size. Worldwide, it is estimated that the total pension fund portfolio has increased to around \$12 trillion, \$7 trillion of which are in the United States (Pension Fund Excellence: Creating Value For Stakeholders by Keith P. Ambachtsheer D. Don Ezra). Given this enormous fund size, the imperatives for tapping contractual savings as an alternative source of funds are growing, particularly in the light of the challenges that have emerged from the Asian financial crisis of 1997.
2. Then again because of the size and the increasing mobility of capital as a result of the trend towards unification and the globalization of financial markets, the movement of pension funds across borders has significantly affected the capital markets in many emerging economies, not only in terms of the volume of transactions but also in terms of the development of new and sophisticated financial instruments. Consequently, the strong influence of these developments on yields in these markets can not be emphasized enough.
3. Pension funds have also increasingly contributed to the growth of the financial system. As a proportion of the assets of the financial system, pension funds account for 6.3% of the combined resources of the financial institutions in the country. It is not hard to see, therefore, the significant influence of the pension funds on the key economic variables as interest rates and the level of transactions as well as price movements in the stock market.

4. Among the stakeholders of the social security institutions, there has emerged a growing awareness on the critical relationships between efficiency of investments of the pension fund and the level of benefits that might be possible for them, including its impact on the viability and the life of the pension fund itself. This growing awareness is not only apparent now among members of a defined contribution pension program and those subscribing to an externally-managed individual retirement account, but also among members of a defined benefit scheme.

Lately, in many fora on social security administrations, a considerable number of discussion papers on the experiences of various countries on the investment of their pension funds have been prepared and documented. As our contribution, I am pleased to briefly relate to you our own experience in this country, with particular focus on the GSIS and the SSS.

But before doing so, allow me to touch a little on the scope and nature of the operations of these public pension funds:

THE GSIS AND THE SSS

Among the developing countries of Asia, the Philippines has the oldest social security programs, and among those with the widest coverage and range of benefits. The GSIS was created in 1936 through the enactment of Commonwealth Act 136, while the SSS came into

being in 1954 by virtue of Republic Act 1162. By design, the GSIS and SSS are both mandatory, publicly managed, defined benefit social insurance schemes with funding coming from members and employers in the form of contributions, and investment income from reserves. The GSIS carries out the program for the employees of the government while the SSS administers the counterpart scheme for the private sector.

Benefits: The current programs provide for old age, disability, survivor, pension, employee compensation, maternity, sickness and funeral benefits. There is no program, however, for family allowance and while there is unemployment benefits for workers in the public sector, there is none presently for employees in the private sector, although legislation to create such benefit program has been under discussion. Likewise, life insurance coverage is provided for public sector employees including the justices, judges and members of the Constitutional Commissions.

Coverage: The GSIS membership, now at 1.42 million consists of all employees of government regardless of employment status except for the uniformed members of the military, the police, jail management and fire protection. The SSS, on the other hand, has extended its coverage to include not only private sector employees but the self employed in 1980, then the farmers and fishermen in 1992, and later the domestic helpers, overseas contract workers and workers in the informal sectors with monthly income of less than P1,000 per month. Presently, the SSS has 19 million registered members with only 7 million actively paying members.

While portability of benefits is deemed inadequate for employees moving from one employer to another in the private sector, the same is not true in the case of workers moving from the private sector to the government sector and vice versa. GSIS and SSS have present arrangements that allow workers to combine credits under the two schemes for purpose of establishing eligibility for benefits.

Government Guaranty: Government has assumed responsibility for maintaining the solvency of the funds of both systems and for guaranteeing the levels of benefits prescribed. Because of the inflationary climate, there is a strong tendency to raise benefit levels periodically in order to offset partly, any diminution in the real value of the benefits. These annual adjustments in benefits, along with the changes in the contribution rates and the policy of investment of the reserve funds, have kept the GSIS and the SSS social security programs within the public and political arena.

Let me now proceed to the core of my presentation.

INVESTMENTS OF THE GSIS AND THE SSS: THE EXPERIENCE

The investment of reserve funds is a critical function for both the GSIS and the SSS. Both institutions have the fiduciary responsibility to make the funds grow and generate respectable returns that would enable them to meet their future obligations in full.

Investment Policies and Guidelines. The basic authority to invest funds not being used and the different areas where GSIS and SSS can channel these funds are spelled out in their respective Charters. Considering that both institutions are given broad powers and wide options where these funds can be placed, they have the advantage of flexibility compared with other pension funds where the entire investible funds are required to be placed only in government securities (e.g., mostly to finance government projects and housing). This arrangement seemed consistent with the requirements of a mandatory defined benefit scheme with pre-funding set-up.

Beyond the legal provisions, written investment guidelines that provide overriding principles and objectives for investing were issued. These guidelines also set the limits of investments and, at the same time, stress sound criteria for maximizing returns consistent with maintaining the safety of principal and liquidity.

Because of the nature of the investments, particularly in the case of equities and government securities, the authority to invest has been delegated by the Governing Board / Commission to the President and General Manager, in the case of the GSIS and to the President, in the case of the SSS. They are, in turn, assisted by investment committees and other operating units tasked to undertake the evaluation of investment proposals.

Asset Mix and Portfolio. As of December 31, 2001, the GSIS investments portfolio amounted to P153.49 billion while that of the SSS reached P154.79 billion, for a combined total of P308.28 billion. In terms of the mix of investments, the GSIS portfolio consists of the following: member loans including individual housing loans, 48%; loans to the private sector, 2%; loans to the government sector, 5%; government securities, 18%; and private equities and securities, 27%.

On the other hand, the SSS investment allocation is as follows: member loans, 25%; loans to the private sector, 8%; loans to the government sector, 24%; government securities, 16% and private equities and securities, 27%.

While the portfolio of both institutions last year appears similar, the comparative distribution over the past 20 years provides some indications on the strategy taken by each of the institutions in investing their respective funds.

Investment Strategy. During the earlier years of fund accumulation, both GSIS and SSS concentrated on member loans such as salary and housing loans. The loans were then given at concessional rates since, at that time, there was an urgent perceived need from members for these types of financial assistance. Hence, while there was an interest cap policy of 12%, salary loan rate was at 8%.

In the particular case of the SSS which started operations in 1958, obviously much later than the GSIS, the concentration on these loans may have been designed to encourage private employees and employers to comply with the provision of the SSS law. At the same, there was already a pressure on the SSS to provide the same facility to its members in the same way that the GSIS has done. During those times, given that the financial market is not yet developed, there was also very limited placement options.

But for both institutions, there was basic concern on how to "ration" or allocate the available investible funds without running into liquidity problems, considering that the build-up of funds has not yet accelerated.

In the early seventies, the GSIS started to gradually place funds with government corporations and private companies in the form of loans or equity participation. This grew steadily throughout the next two decades. Likewise, as a result of the short bull-run experienced during the period, the GSIS began channelling some funds to the stock market. Some of the investments in stocks made at that time gave the GSIS considerable returns (e.g., San Miguel, PLDT and Ayala Corporation shares), particularly when it unloaded these shares during the market run-up of 1993. Unfortunately, however, quite a number have remained locked up until the present.

When the mid-seventies came, the GSIS (together with the Development Bank of the Philippines, another government financial institution) became heavily involved in the financing of the construction of hotels as a result of the government's bid to host the World Bank and the IMF Meeting in Manila. Most of these hotels were privatized later in the late eighties and early nineties. It was also during this period that the GSIS took over ownership of the Philippine Airlines, the Philippine flag carrier. It should be mentioned that since the country was under the Martial Law Regime during this period, the government exerted strong influence on the investment priorities of most institutions.

It was not until the late eighties that GSIS started to invest in government securities. Volume of investment in this area remained moderate until 1998 when both the real estate and equities market precipitously fell after the 1997 financial crisis.

The period also saw the GSIS' and the SSS' increasing participation in the national shelter program of the government. By the strength of an Executive Order, the two pension funds were directed to take out housing loan mortgages originated by a newly established agency, the National Home Mortgage Finance Corporation (NHMFC). The objective then was for these institutions, together with the Home Development Mutual Fund or Pag-ibig Fund, to jumpstart the development of the secondary market for housing mortgages. Total

allocations made by GSIS for this program from 1989 to 1998 reached about P9 Billion while those of the SSS hovered around P30 Billion.

Active participation of the GSIS in the stock market resumed in 1988 when the volume of transactions in the exchange started building-up, partly triggered by the entry of foreign investors and strong interest of domestic investors. Then in 1992, following the lead of the SSS, the GSIS opened up lending windows to members for entrepreneurial endeavors through cooperatives and for the purchase of shares of stocks. This was followed by the participation of the GSIS in the pre-need industry through its educational and memorial pre-need products and in the distribution of T-Bills to small investors under its "Angat-Yaman T-Bills Program". All of these retail investment programs were terminated in mid-1998 in line with the "back-to-the-basics policy" adopted in that year.

In pursuit of diversification, the GSIS in 1994 invested in foreign markets with a US\$10 million initial exposure. The venture became profitable but it had to pull out the funds after two years due to government and public pressures.

With the onset of the financial crisis in mid-1997 to date, GSIS investment priority has shifted focus, from real estate loans and equities to member-loans and government securities. Loan programs to members were repackaged and re-oriented into investment options for the fund rather than additional benefits under the pension scheme.

In the case of SSS, the concentration of investment, at first, was in member loans (e.g., housing and salary loans). But since the treasury bills program was launched in 1969, the SSS set aside a significant proportion of its funds for the purchase of these government securities (GS). Subsequently, the pension fund acquired longer-term instruments, in considerable volume also, when the government initiated the issuance of securities with more than one year maturities (such as Treasury Notes) as part of the state's objective of developing the market for government securities.

Towards the late seventies, loans to private corporations and enterprises, were made increasingly through two government financial institutions, the Philippine National Bank, then the largest bank in the country, and the DBP. By 1986, SSS was holding a considerable amount of Philnabank Bills and DBP Promissory Notes, representing the volume of loans funded by the SSS placements. When the PNB and the DBP were rehabilitated sometime in 1987, part of these receivables (mostly non-performing loans) were agreed to be absorbed by the National Government. SSS then requested the National Government to convert these Philnabank Bills and DBP Promissory Notes to Treasury Bills on the maturity dates of each of these bills and notes.

The scheme of conversion of these PNB and DBP notes into T-Bills proved to be an excellent decision for the SSS. When the government in 1991, in an effort to bring down the levels of interests which were then at the high of 25%, negotiated with both the GSIS and the SSS for the conversion of the existing T-Bills in their portfolios into long-term Treasury Notes of three-to-five year maturities and at rates ranging from 20 to 22%, the SSS had so much in its portfolio. A few years later, when the rates started to go down, the SSS (and for that matter GSIS) found its GS portfolio way ahead of the market.

It was not until 1987, that SSS started to invest in equities and regularly participated in the stock market transactions. Co-incidentally at that time, after a long lull in activities since late 1970's, increasing volume of transactions in the stock market were recorded. Increasing participation of the two pension funds has in part contributed to these renewed activities. This trend later on developed into a "bull run" and lasted up to 1993, except for a short period in the later part of 1989 when the U.S. stock market experienced almost a "free fall" and when some political disturbances hit the home front. During the period, actual trading gains from the market regularly provided additional sources of growth for the fund. For both GSIS and SSS, however, the record earnings were made in 1999 when a short rally in the stock market was experienced, after the financial crisis in July, 1997.

It should be mentioned that SSS and later on GSIS took active participation in the short and mild rally in the latter part of 1998 in the stock market which was brought about by (a) initiatives taken by some investors to buy-into existing companies particularly utility companies, (b) interest in the banking sector for merger opportunities which was encouraged by the Central Bank to strengthen the banking sector and (c) expansion plans of some domestic companies to compete in other parts of the region.

With the slump in the stock market starting the latter part of year 2000, SSS (as in the case of the GSIS) drastically reduced its participation in the stock market and focused its investment on its "omnibus" loan program (i.e., loans to small and medium scale loans and housing loans which are being conduited through banks) and in government securities.

Investment Performance. The investment performance of the GSIS and the SSS in the past 20 years has been mixed. Despite the fluctuations in interest and portfolio yield rates, the investment income of both the GSIS and the SSS continued to grow during the last 20 years (1981-2000). In the case of the GSIS, the average investment income per year grew to P2.32 billion for the period 1996-2000 from P360.91 million in the period 1981-1985. The SSS' investment income, on the other hand, rose to P13.86 billion from P2.15 billion during the same period.

Further in the case of the GSIS, its annual ROIs during this 20-year period fluctuated from 1.73% to 10.58% while SSS ROIs varied from 7.02% to 26.09% during the same 20-year period.

It is worthy to mention that, on the average, the investment returns of the GSIS and the SSS during the period 1981 – 2000 fared well when compared with the annual pension fund returns of other developing countries.

OBSERVATIONS

My review of the investment policy directions of the GSIS and the SSS leads me to the following observations:

1. Government Influence

The government has influenced the use of public pension funds to attain a variety of public policy objectives, although, of course, this is not only true in this country. Given the large pool of funds, it is often tempting for government bodies to direct the investment of a portion of these assets for specific domestic political purposes, such as low income housing, financing start-up businesses and development of the capital market, among others. While well-intended, these economically targetted investments normally lead to less than market rates of return and thus deviate from fiduciary principles.

It has also been observed that the head of the institution, at the same time, exerts strong influence on the direction and investment strategies of the portfolio. For both GSIS and SSS, the channelling of the bigger chunk of the investible funds to either government securities or equities reflects the preferences of the heads of the institution as influenced by their levels of experience, exposure and orientation.

2. Short-term Nature of Portfolio

The investment portfolio of the public pension funds has been largely short-term in nature, although there has been significant efforts lately to correct the mismatch between the long-term liabilities of the funds and the short-term maturities of assets. Member loans and government securities with short-term tenors have consistently been the two major investment outlets of the public pension funds. The concentration of these instruments, however, is understandable in the light of my third observation.

3. Limited Investment Opportunities in the Domestic Market

There is a dearth of available investment instruments in the domestic market, particularly those with long-term maturities. While, of late, the government has issued 5- to 10- year maturities, there is still so much to be desired in the frequency and the amount of offerings being made.

The narrowness and lack of depth of the local stock market has not also provided a good alternative investment channel for the pension funds. The World Bank, in one of its country reports, said that the historical experience of most countries has confirmed that equity investments overtime generate much higher returns and provide needed liquidity for the funds more than the other types of assets. The GSIS and the SSS have yet to benefit fully from this general observation. To date, the two institutions have locked-in a sizable portion of their investments portfolio in some under- performing shares and with the current slump, not only their yields but also their liquidity positions are greatly affected.

4. Limited Options for Diversification

Diversification of the portfolio has, thus, become slow and limited. The situation, though, is justifiable given that the country's capital market is still in the stage of development where the infrastructure supports (such as the regulatory framework and legislative mandates) are yet in the process of being put up. While an alternative option is to invest offshore as legislated authorities have already been granted, the pension funds have been hesitant to explore this market because of possible public backlash in the face of the government's thrust to lure foreign investors into the country.

5. Inadequate In-House Expertise

The in-house fund managers of GSIS and SSS are not ready, as of yet, to meet the growing sophistication of the capital market. The lack of exposure and the utter absence of training opportunities on the management of a global portfolio are concerns that need to be addressed if the pension funds are to tap the foreign markets as investment options.

OPPORTUNITIES AND CHALLENGES

Among us in the field of social security, the importance of investment in ensuring the viability of the fund need not be over-emphasized. Today, the task of investing the pension funds has become more challenging than ever before given the changing demographics, macro-economic conditions in our respective countries, and globalization, among others. Moreover, the enhanced authorities and flexibilities in the use of these funds, particularly with respect to the areas where these funds can be channeled have increased the pressures on fund managers to achieve maximize returns and profitability on these assets.

To my mind, there are several opportunities and challenges for fund administrators in the Philippines which have become more pronounced in recent years:

1. First, is the challenge to provide sufficient autonomy to pension funds to permit them to assign greater weight on their fiduciary responsibilities of maximizing returns for their members. This does not imply that these funds should not be used in exceptional cases for broad national objectives. However, routine disregard of economic efficiency and commercial return considerations in investment decisions involving pension funds is not compatible with their fiduciary responsibilities.
2. Second, in connection with the performance of the pension fund's fiduciary responsibilities, Corporate Governance must be improved. The corporate structure, administrative and investment procedures, appointment process of qualified Trustees and accountability of top officials must not only be addressed but must also be benchmarked with international standards.
3. Third, among members and stakeholders, transparency is now becoming to be a major issue against public pension funds. Social security schemes are increasingly criticized on a number of counts, including their design, their administration and their investment performance. Public fund administrators are increasingly called upon to disclose and explain to the members investment policies and decisions as well as the investment performance of the fund.

The growing demand of the members for transparency, on the other hand, creates an opportunity to review the propriety of the existing governance structure and procedures in the appointment of the members of the governing boards of the funds. At present, all the members of the policy making bodies of the pension funds are political appointees. Moreover, the CEO serves at the pleasure of the appointing authority. The situation makes the management vulnerable to political influences.

As in the case with many pension fund schemes in developing countries, the policy-making Board/ Commission of the GSIS and the SSS reflects a tripartite structure. Of late, this structure has been noted to have been stymied by narrow sectoral interests. Thus, there is an emerging need to look for a more appropriate set-up/ arrangement that will balance the interests of all the stakeholders of the funds.

4. Fourth, is the challenge of improving fund management capabilities. Toward this end, both GSIS and SSS are now considering contracting out a portion of their investible funds to external fund managers – domestic and foreign. This arrangement will insulate the funds from political intervention and would allow for competition between the in-house and external fund managers for improved returns. In-house asset allocation capability should be strengthened to gain expertise

and enhance ability to monitor performance of the fund managers.

5. Corollary to the above is the challenge to develop a performance measurement system, which is a prerequisite to effective investment. Performance measurement entails a precise calculation of the return of the pension fund over a given period of time, followed by a further assessment which may include calculation of risks, of performance relative to other pension funds, performance relative to the market and performance relative to an absolute benchmark. In general, addressing this challenge is to ensure that investment is efficient relative to the opportunities available.
6. Sixth, given the lack of depth of the domestic financial and capital market, diversification of the portfolio has become a compelling challenge, not only in terms of the investment media but also in terms of geographic areas. Decisions to do offshore investments must be carefully studied, taking particular focus on foreign exchange risks and benchmarking, as well as on monitoring and evaluation tools and capabilities available.
7. Seventh, the conversion into earning assets of the accumulated investment accounts (e.g., loans and securities) which did not meet and, in fact, fell below the return expectations is a big task facing the fund administrators of both GSIS and the SSS. The two institutions recognize the need to "move" these non-

performing assets to make them productive and positively impact the long-term viability of the funds.

In the case of the GSIS, the securitization of these assets is being looked into. The goal is not only to liquefy these assets but also to enhance the returns on the over-all portfolio. It is also studying the feasibility and practicability of creating an Index Fund, which will mirror the local Phisix. Initially, the GSIS is looking at the possibility of having this Fund listed in both the local bourse and in some foreign exchanges.

CONCLUSION

In a short span of time, we have covered a lot of ground as we tried to highlight the investment experience of the public pension funds in the Philippines. This is in the hope that our friends from our neighboring countries will be able to tap into and learn from the wealth of our country's experiences, experiments, innovations, failures and successes in this area of social security administration.

Admittedly, devising a prudent, yet remunerative, investment portfolio remains a difficult task in countries such as ours where the financial and capital markets are still being developed and where transparency and information flows are inadequate. The challenge has become more intense against the backdrop of the new global order and discipline. In our common dream to provide for old age in the best

possible way we can, the Philippine pension system is compelled to take on the challenge.

Thank you very much and I wish you all success in your forthcoming discussions.

Good day!