Pathfinder Economic Flash

Don't Throw the Baby Out with the Bath Water.

Considerable controversy has arisen regarding Employment Provident Fund (EPF) investment in the Colombo Stock Exchange (CSE). There have even been calls to stop all such investments. It is important, however, to remember that there are positive arguments in favour of such investments. However, it is necessary to create the appropriate enabling environment to avoid criticism based on conflicts of interest, a lack of transparency and an erosion of investor confidence.

The EPF investments in the CSE play a useful role in increasing liquidity in a thin market. They can, therefore, have a positive impact in terms of capital market development. Such investments also create the opportunity to secure higher rates of return for EPF members, provided the investments are handled professionally. It should also be recognized that public sector pension funds around the world do include shares in their overall investment portfolios. China's massive ***National Social Security Fund (NSF)*** not only invests in equity but also uses the services of private equity funds to manage its investments. ***California Public Employees' Retirement System (CALPERS),*** one of the largest public sector pension funds in the world, has large investments in stock markets globally. In addition, in South Korea, the ***National Pension Service (NPS)*** has established a separate unit to undertake investments in equities, mainly in Asian markets. Pension Funds in other countries also invest a prudential share of their assets in stock markets.

Hence it is important that we 'do not throw the baby out with the bath water'. There is a case, instead, to improve the efficacy of the framework for EPF investment in the stock market by introducing three safeguards that would assist in addressing some of the issues that have been brought out by the recent public debate on the subject.

1. The current guidelines for EPF investments in the stock market should be transparent and made available to the public.
2. A unit, which is run by investment professionals, separate from the Central Bank should be established to undertake these investments. Consideration could also be given to using private fund managers on a performance-based fee scheme to run part of the portfolio as in China. This would address issues related to conflicts of interest that arise from the Central Bank not only administering the EPF but also regulating financial institutions which account for a large share of market capitalization.
3. The EPF should be a passive investor that does not seek a presence in the boards of private companies. This would serve to address confidence-related concerns that have arisen regarding government involvement in the running of private companies, among both domestic and foreign investors. This at a time when Sri Lanka needs to maximize private investment to meet the government's growth and employment targets. The oversight related arguments that could be made for a Government Board presence are less persuasive in the case of listed companies which are subject to strict accounting and disclosure rules.

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