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The Need to Set a Fiscal Target and Improve the Fund Governance Structure of the National Pension in Korea

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The Need to Set a Fiscal Target and Improve the Fund Governance Structure of the National Pension in Korea

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Setting an explicit fiscal target in the pension system and implementing stronger fund governance are needed to address the concerns regarding the projected rise and fall of the National Pension Fund in Korea. Strengthening expertise and accountability of the fiduciaries is essential for a better governance structure, but their role must be confined by the mandate derived in part from the fiscal target of the pension system. Hence, setting the fiscal target, which provides a link between the pension system and pension fund governance, may be the first step to advancing the governance structure of the National Pension Fund.

I. Introduction

The National Pension Fund (NPF) in Korea is expected to grow rapidly during the coming decades, rising from 10% of GDP to nearly 50% at its peak. Without major reform in the public pension system, the ongoing accumulation of the fund will be followed by an equally rapid decumulation phase. This projected rise and fall in the Fund's size

Enhancing expertise and accountability is imperative in reforming the governing body, which should be accountable for long-term investment performance necessary to meet the National Pension's fiscal target.

raises concerns over the capability of the current governing body to handle the outsized investments in Korea's domestic capital market and to efficiently diversify into overseas investments. The expected large-scale asset sales during the decumulation phase are of particular concern as they may drive down share prices and hence, the Fund's own asset values. Given the magnitude of these fluctuations in the Fund's size, adept management of its assets and liabilities will be crucial to minimize potential adverse consequences to Korea's capital market.

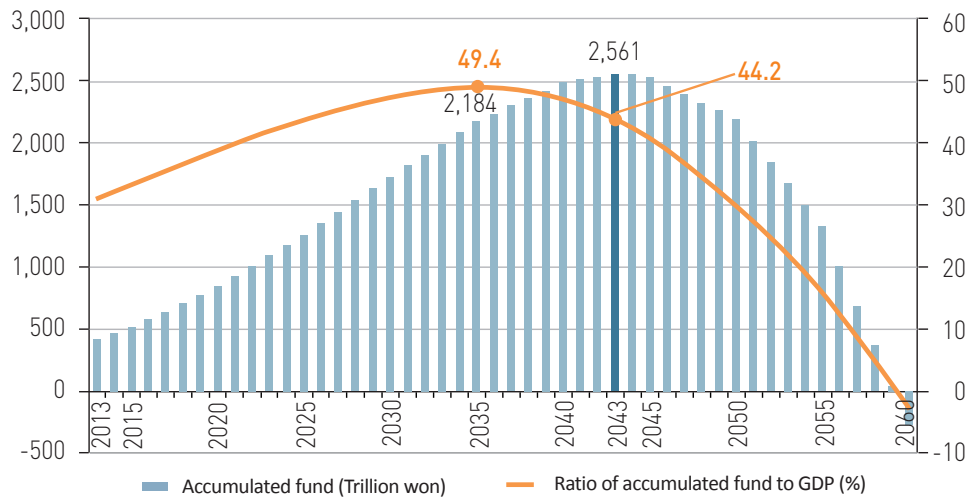
To successfully overcome these challenges, we argue that board members must be selected based primarily on their professional capacity and expertise in investment and economics, which will be required to competently manage the Fund while recognizing the implications for Korea's capital market. At the same time, a well-designed incentive structure has to be imposed on the board to prevent the fiduciaries from pursuing objectives that may conflict with the interests of the Fund's owners, and from being discouraged by the lack of proper compensation and professional discretion commonly found among the public sector.

Previous attempts to strengthen expertise in public fund management have been largely fruitless, confronted with widespread suspicion that a board consisting purely of agents such as financial experts or government officials, without union representatives and employers, may abuse the Fund for purposes other than the interests of the owners, as can be seen in the Japanese government's recent attempt to mobilize the national pension fund to boost Japan's stock market. Therefore, any successful reform proposal to strengthen expertise has to be accompanied by measures addressing the concerns over the accountability of the governing body.

The National Pension Fund has built up to 32.7% of market capitalization or 28.3% of domestic bonds outstanding. It is expected to grow further before it is rapidly liquidated and depleted.

One prerequisite for ensuring accountability in the Fund's governance structure is to set a long-term fiscal target for the National Pension. If given a fiscal target, the required investment returns to meet the target can be obtained, which in turn will provide fund managers with a clear mandate to guide their investment strategies and serve as a criterion for performance evaluation. Unfortunately, the National Pension in Korea lacks a clear fiscal target as it is unsustainable in its current form despite several rounds of benefit cuts, and not much has been agreed on regarding a path to reform. This uncertainty leaves the Fund's investment objective obscure, which hinders efficient management. Therefore, setting the fiscal target for a sustainable pension system may be the first step to advancing the governance structure of the pension fund.

[Figure 1] Estimated Size of National Pension Fund



Source: Financial Projection Committee for National Pension, 『Long-term Projection for National Pension』 Oct. 2013.

II . Current Status

The market value of NPF totals 484 trillion won as of Dec. 31, 2013, of which 333 trillion won comes from contributions and the remaining 150 trillion won from investment returns. The size of the accumulation amounts to 32.7% of domestic stock market capitalization (36.6% of KOSPI) and 28.3% of domestic bonds outstanding.¹⁾

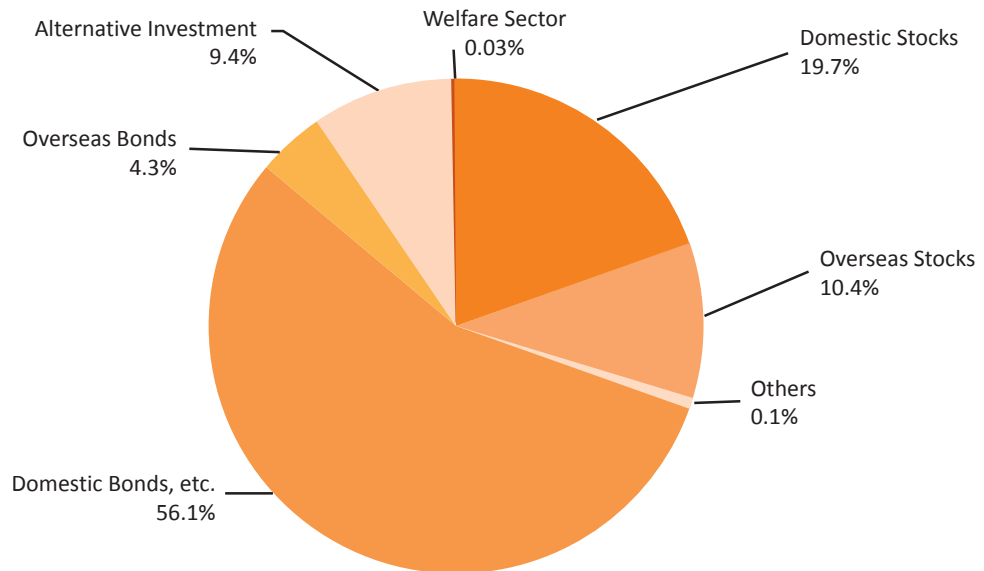
Notably, this already enormous fund will continue to grow before reaching its peak in 2035 at 2,561 trillion won. It will be liquidated fast during the subsequent fifteen years before entirely depleting in 2060, according to the official actuarial projection (Figure 1). This rise and fall of the pension fund may constitute a large shock to the domestic capital market, although it is not unexpected.

To minimize the impact of the changes in the Fund, agile and professional responses to the developments in the domestic capital market as well as further diversification into overseas investments will be necessary.²⁾ In addition to the expertise of decision makers, the governance structure will matter as it will enable them to make prompt decisions to respond to changing market conditions. Also, transparency in fund management will become increasingly important as the Fund's control over corporate governance will increase with the rising ownership share of the Fund among individual companies.

1) 2013 National Pension Statistical Yearbook; Bond Information Service: <http://www.kofiabond.or.kr/index.html> (the latest access date: Feb. 2, 2015).

2) The most desirable policy response would be to maintain an appropriate funding level and avoid rapid liquidation of pension assets by reforming the national pension scheme. However, it would be still important to diversify investment and manage funds skillfully.

[Figure 2] Asset Composition of National Fund (As of late 2013)



Note: 1. Domestic bonds, etc. include domestic bonds and short-term funds; Welfare sector includes Welfare town (Cheongpung Resort), rental of facilities for child-care and the elderly, credit recovery support funds, emergency funds for the elderly (Silver Loan); Others include acquisition cost of buildings, deposits for rent and money held temporarily.

2. Alternative investment is compared against investment in conventional financial products including listed stocks and bonds. Currently alternative investment is made in real estate, social overhead capital (SOC) and private equity fund (venture, corporate restructuring company (CRC), private equity).

Source: 2013 National Pension Statistical Yearbook (National Pension Research Institute, June 2014); 2013 National Pension Statistics (National Pension Research Institute, Aug. 2014)

III . Investment Strategies and Performance of the NPF

In general, the optimal allocation of pension assets depends on the life-cycle of pension funds: when the pension system is young and hence the fund is expected to keep growing, investment on risky assets seeking higher returns may be desirable as fund managers can ride out market fluctuations that the risky assets entail. Furthermore, the scope for long-term investment enables fund managers to garner the liquidity premium as well (Park 2007).

Passive and trend-chasing investment behavior prevails in the accumulation phase of the NPF where risk-taking can be desirable.

However, it has been often pointed out that the current asset mix and investment strategies of the NPF exhibit passivity typical of a fully mature pension fund wherein the priority lies in the liquidity for pension payments, rather than higher returns. This is indicative of flaws in the governance structure that may inhibit fund managers from fully demonstrating their potential. For example, the bond share of the Fund's investment stands at 60.4% as of Dec. 31, 2013, much higher than that of major public pension funds with the exception of the public pension fund in Japan, whose system is fully mature while the equity share of the Fund investment is only 15% (Figure 2). The latter falls far short of the target of 38% recommended in 2004 by the Master Plan for National Pension Fund

<Table 1> 1-year Return on Investments in Stocks (Overseas, Domestic) and Alternative Investment by Major Pension Funds

Pension Funds (Country, Base Period)	Return on Investment (%)			
	Overseas Stocks	Domestic Stocks	Alternative Investment ^{1:}	Total
National Pension (Korea, as of late 2013)	9.4	-5.5	12.3	5.2
CPPIB (Canada, as of late Mar. 2014)	27.4	16.6	17.5	16.5
CalPERS (US, as of late June 2014)	24.8		13.4	18.4
GPIF (Japan, as of late Mar. 2014)	32.0	18.1	-	8.6
AP1 (Sweden, as of late 2013)	13.5 ^{2:}	13.2	11.5	14.8

Note: 1. Return on alternative investments for CPPIB, CalPERS, and AP1 was calculated using weighted average of return on investment figures for each equity considering the share of each asset.

2. Return on investments in overseas stocks of AP1 was calculated using weighted average of return on investments in advanced countries' stocks of 10.4% and return on investments in emerging countries' stock of 21.1% considering the share of each asset (24.7%, 10.1% respectively).

Source: 1. National Pension, http://fund.nps.or.kr/jspage/fund/mcs/mcs_03_02.jsp (the latest access date: Feb. 9, 2015)

2. CPPIB, 2014 Annual Report(CPPIB), <http://www.cppib.com/> (the latest access date: Jan. 26, 2015)

3. CalPERS, Comprehensive Annual Financial Reports 13/14, <http://www.calpers.ca.gov/> (the latest access date: Feb. 9, 2015)

4. GPIF, Review of Operations in Fiscal 2013(GPIF), <http://www.gpif.go.jp/en/fund/> (the latest access date: Jan. 30, 2015)

5. AP1, Annual Report 2013, <http://www.ap1.se/en/> (the latest access date: Feb. 9, 2015)

Management prepared by the Ministry of Health and Welfare. Compared to several major public pension funds, the NPF underperformed in each asset class (Table 1).

Passive and idle investment strategies taken by the NPF have often been criticized in other respects too. Among the companies of which the Fund owns more than 5% of shares, fifteen companies are ranked within the top 20 in terms of market capitalization. The herd behavior chasing higher market-capitalization stocks suggests passive and trend-following investment, rather than active and thorough searching for assets that offer higher returns at a given risk level.

The tendency to seek momentum in equity picking has been noted among outside fund management companies who are under contract with the NPF. Momentum investing hints at complacency in management under which trend-following behaviors commonly lead to disproportionate weight in the stock portfolio on equities with good past performances over those with bad past performances. It therefore makes it difficult to determine fund managers' capabilities. Currently, the NPF-entrusted asset management companies invariably focus on momentum-biased equity portfolio, and hence rarely exhibit stock-picking capabilities, or "alpha" generating capacities (Jeong 2013; Nam and Lee 2008).

A 5.2% rate of return of the NPF is well below the double-digit rate of returns achieved by other comparable public pension funds such as the CPPIB and CalPERS.

IV . Importance of Fund Governance and the Role of a Fiscal Target

Better fund governance is associated with better investment performance possibly due to more efficient asset allocation.

Empirical studies have shown that governance quality is positively associated with fund performance (Useem and Hess 2001). A good governance structure enables the fiduciaries, who have appropriate expertise and responsibility, to manage funds for the interests of the contributors and beneficiaries. The key to good governance is a clear law regarding the mandate and liability of the governing body or persons, and the subject to whom it is accountable (Maher 2004).

In particular, the role of the board of directors (equivalent to the National Pension Fund Management Committee in Korea; hereafter the Committee) is crucial in the pension fund governance structure as they determine the strategic asset allocation, which in turn explains more than 90% of the variations in investment return.³⁾ The board of directors is also responsible for making other major decisions including approval of investment policies and setting the criteria for performance evaluations.⁴⁾

For effective governance, fiduciary duties of the governing body should be made statutory (World Bank, 2004). It is also desirable to fully utilize the expertise of the fiduciaries by allowing them to decide on investment policies at their discretion, while making them accountable for their decisions. Likewise, ensuring the terms of the board members and providing competitive compensation that is performance-based should be balanced with the statutory requirements for their fiduciary duties and dismissal provisions in cases where there is a breach.

Although managing funds is often thought to be separated from administering the pension system, fiscal targets that may be determined at the administrative level have direct implications for fund management. Long-term fiscal targets provide board members with a scope of their roles within which they can make decisions at their discretion and, in some cases, establish an investment target, based on which their long-term performance will be evaluated.

Having a clear fiscal target indicates that the pension system is sustainable in the long-term. For example, the Canada Pension Plan, which is currently regarded to have the most advanced fund governance structure, reformed its system in 1997 with the fiscal target aimed at maintaining the funding ratio (asset/implicit liability) at 20% and contribution rate at 9%. In the following year, the Canada Pension Plan Investment Board (CPPIB) began working as an independent governing body for fund management with the objective to achieve a long-term investment rate of return of 4%, which is necessary to meet the fiscal target. In this way, the CPPIB was given a clear mission, based on which the board members can set their investment strategies.

3) See Brinson et al. (1991).

4) Fiduciaries include the board of directors as well as in-house and external fund managers.

V . Problems in NPF Governance

1. Unclear mandates due to lack of a fiscal target

Currently, the National Pension is deemed to be in transition but the path to reform is uncertain without a consensus, even among experts. Without major reform, it is to become a pure PAYGO system eventually; but it is still possible that partial funding could be maintained by raising the contribution rate before the fund depletes. The replacement rate has been lowered by two rounds of pension reforms, but the benefit cuts fall short of achieving a sustainable pension system.

Without a roadmap to achieving a sustainable system, a long-term fiscal target cannot be established which would provide the governing body with a clear mandate regarding the target risks and returns.⁵⁾ Not knowing the due risks, fund managers cannot demonstrate their full potential as they are subject to regular audits. Setting a fiscal target is also useful for evaluating the prudence of investment policies as it can be judged against the ultimate objective of achieving the given fiscal target.

2. Lack of Expertise

The current Committee is organized mainly to represent stakeholders including the contributors, beneficiaries, and government. As only two out of the twenty committee members have some expertise in investment, they cannot be expected to properly review expert investment proposals from management.⁶⁾ The minutes of recent Committee meetings (2009-2014) show that, due to a lack of members' expertise required to address the agenda, considerable time was spent on explaining finance concepts to members, some of whom lack knowledge on even the most basic concepts.

This lack of expertise of Committee members leads to substantial inefficiency in the decision-making process such as hindering timely investment decisions as well as discouraging management from proposing new investment strategies that maybe too technical to explain for the financially-illiterate committee members.⁷⁾ For example, the repeated rejections of the proposal to shift the Fund's portfolio toward investment on hedge-funds have often been attributed to the failure of the committee members to understand it.

The mandate given to the NPF is unclear due to the lack of a long-term fiscal target for the pension system for which reform has been delayed.

Committee members are often unable to understand proposed investment strategies and thus reluctant to adjust the existing asset allocation.

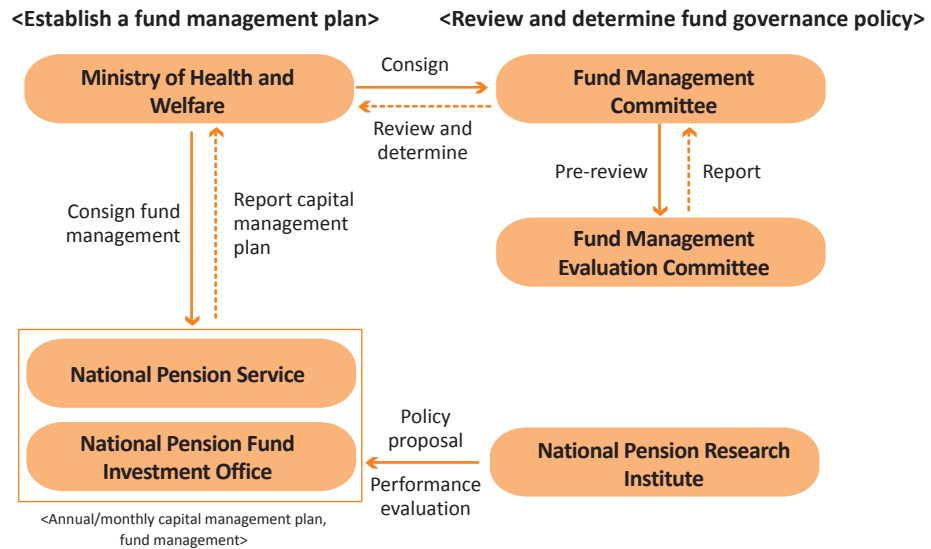
5) As the pension system matures, the interest is growing on managing liabilities as well as assets (so called asset-liability management or ALM). Nevertheless, the benefit of ALM will be clearly limited given the absence of fiscal target and blue print for the system's future path.

6) The Committee consists of six ex-officio government officials including the Minister of Health and Welfare, twelve members representing contributors and beneficiaries, and two pension experts.

7) Reportedly, it is not unusual that those Committee members who failed to understand the investment proposals even after lengthy explanations to state "I am against it because I don't know what it is (Chosun Biz, Dec. 30, 2014)."

Absenteeism is common especially among ex-officio members, who attend one in every six meetings.

[Figure 3] Establishment of a Fund Management Plan



3. Lack of Accountability

① Self-approval of the investment plan

The Ministry of Health and Welfare both proposes and approves the fund management plan although the Committee is nominally responsible for the approval.

The key to accountability in governance structure is the separation of those who present investment proposals and implement investment decisions (fund managers) from those who review and approve the proposals and monitor the implementation (Fama and Jensen, 1983; OECD, 2005). However, such separation is far from clear-cut in the governance structure of the NPF as the Ministry of Health and Welfare effectively proposes fund management plans as well as approves them. As can be seen in Figure 3, the annual fund management is drafted by management based on the guidelines prepared by the Ministry of Health and Welfare, and it is approved at the Fund Management Committee chaired by the Minister of Health and Welfare. In other words, the current governance structure allows for the fund management plan to be both proposed and approved by under the auspice of the Minister of Health and Welfare.⁸⁾

② Accountable to whom?

The Investment Office, of which the officer is appointed by the board of directors,

8) "In every meeting," one Committee member complained, "I feel like a stamping machine in a dark room (the National Pension Fund Management Committee, 2009)."

<Table 2> Attendance Rate of Fund Management Committee Members (2009 to 2014)

(Unit:%)

Year	Ex-officio Members	Appointed Members			
	Relevant Ministries (4)	Employer Representative (3)	Workers Representative (3)	Representative of Self- Employed Insured (6)	Relevant Experts (2)
2009~14	16.2	75.5	79.4	71.6	79.4

Source: Each year's meeting minutes of the Fund Management Committee

implements the investment policies approved by the board on a daily basis. Hence, it should be accountable to the Committee. In practice, however, the Investment Office of the NPF does not belong to the Committee of the NPF, but to the National Pension Service (NPS), a government agency, which is in charge of the administration not management of funds. Also, the Chief Investment Officer who should be accountable to the Committee is controlled and appointed by the Chief Executive Officer (CEO) and the Minister of Health and Welfare. Furthermore, the Risk Management Office whose role is to oversee the prudent management of assets by the Investment Office is also controlled by the CEO who is effectively controlling the Investment Office. Finally, absenteeism among government officials from regular Committee meetings testifies to the lack of accountability in the current governance structure (Table 2).

A clear mandate should be given to the independent governing body, which in turn is accountable for the given mandate.

③ Conflict of interest in performance evaluation

The NPF is subject to annual performance evaluations and audits conducted by the National Pension Research Institute and an external consultation firm. In spite of the external audits, the audit process may not be entirely free from the influence of the NPS CEO as the external audit firm is chosen by the NPS. This suggests potential conflict of interests of the CEO to the extent that a negative evaluation of the fund management will adversely affect the reputation of the CEO as well as its own evaluation.

VI. Suggestions for the Improvement of the Fund Governance Structure

There have been discussions on reforming the NPF governance with the emphasis on the need to increase the rate of return on investments. A well-known estimate is that a one percentage point increase in the rate of return on investment would have an impact of delaying fund depletion by eight years, an impact equivalent to increasing the contribution rate by two percentage points. However, previous attempts to reform governance have been futile owing to prevailing distrust in the financial experts who will control pension funds in a reformed governance structure as well as popular support for using pension

The Committee must be stand-alone and responsible for the Fund Investment Office, which currently belongs to the NPS, a government agency.

Previous reform proposals were discarded due to the popular suspicion that the governing body controlled by financial experts may take excessive risks or seek their own interests and not those of contributors and beneficiaries.

funds to enhance general public welfare.⁹⁾

To advance the reform discussion further, it would be necessary to first establish the principles in designing a pension fund governance structure. Above all, the top-notch financiers should be employed to achieve an optimal combination of risk and return in the pension fund portfolio; but the set of the optimal combinations should be given beforehand from the highest level of governance. At the same time, concerns over potential conflict of interests among the fiduciaries should be adequately addressed by implementing a strong accountability framework.

The principles we suggest can be summarized as follows. First, a clear fiscal target, say a lower bound for the funding ratio, should be provided. A fiscal target will set the scope and the boundary for the role of the fund management. As the fiscal target can be subject to change, we suggest it should be reviewed and announced regularly by the National Pension Review Committee and the process to be specified within the National Pension Act.¹⁰⁾

Second, a major overhaul of the Committee is necessary. A new governing body, independent of the government and consisting of members chosen primarily for their professional experiences and appropriate expertise, should be established to control and oversee fund management effectively.

Finally, the governing body and management have to be subject to regular external audits. As the duties and liabilities of the fiduciaries are statutory, the board members need be granted legal authority to evaluate the staff and provide them with appropriate incentives to enhance performance. ■

9) See Appendix.

10) Accordingly, investment directives should include the specified level of risk and rate of return that are consistent with the fiscal target.

Appendix

Previous Attempts to Improve Governance

When the National Pension Plan was launched, the government's intentions were ensured with eight government officials among the 15 members of the Fund Management Committee and the panel chaired by the Minister of the Economic Planning Board. The dependence on government guidance deepened during the Kim Young-sam administration; as the fund for social overhead capital expansion was necessary to pursue neo-economic policy at that time.

The management of the national pension fund was transferred to the Public Capital Management Committee with the enactment of the Public Capital Management Fund Act in 1993. Among the 15 members of the committee, 11 were to be appointed by heads of government ministries and 4 by the Minister of Economic Planning Board. Accordingly, contributions to the pension fund were deposited into the Fiscal Financing Special Account to finance projects, including expansion of social overhead capital, and support for SMEs and farming and fishing communities.

The second transition was made during the 1997 Asian Financial Crisis. At that time, the World Bank made abolition of mandatory deposit system a condition for its structural adjustment loan (SAL). The Kim Dae-jung administration complied and increased the number of insurant representatives to over half of the members and changed the head of the Fund Management Committee from the Minister of Finance and Economy to the Minister of Health and Welfare.

The third attempt is still underway. A number of attempts to improve the National Pension Plan have made the improvement of management expertise the highest priority. The Participatory Government tried to establish the Fund Management Corporation by separating the Fund Investment Office and reshape the Fund Management Committee into an independent administrative committee led by experts.

These attempts failed and discussions on reshaping the system resumed in 2007 with a plan to have the Ministry of Health and Welfare make the Fund Management Committee a private, independent and standing organization and the National Pension Fund Management Corporation established as a management company that is also independent and filled with experts. Under the Lee Myeong-bak administration, the plan was revised, resubmitted and put to the National Assembly after the cabinet meeting in 2008 but the discussion was halted due to global financial crisis. Currently, two improvement plans have been submitted to the National Assembly.

This process is in line with the general trend of advanced countries, where the most important task of the public pension fund moves from securing independence from the

government to improvement of fund management efficiency (World Bank, 2004). But, it has been brought to light that the approach to improving the management of funds has been fragmented and not integrated with the reform of pension finance.

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