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Investment Fund

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**OPTIONS TO IMPROVE THE GOVERNANCE AND INVESTMENT OF JAPAN'S
GOVERNMENT PENSION INVESTMENT FUND**

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ABSTRACT / RÉSUMÉ

Options to Improve the Governance and Investment of Japan's Government Pension Investment Fund

This paper suggests avenues for strengthening the governance and management of the Japanese Government Pension Investment Fund (GPIF), the largest single pool of pension assets in the world. The GPIF earned its name in 2006 as part of a major governance reform that aimed at increasing the transparency and autonomy of the fund. While much improved, the new governance structure still falls short of international best practices and in some aspects does not meet some of the basic criteria contained in OECD recommendations, in particular the *OECD Guidelines for Pension Fund Governance*.

JEL codes: G18, G23, G28

Keywords: pension funds, public pensions, social security, reserve funds, asset management, governance

Options pour renforcer la gouvernance et la gestion du Fond d'Investissement des Pensions du Gouvernement japonais

Ce document suggère des solutions pour renforcer la gouvernance et la gestion du Fond d'Investissement des Pensions du Gouvernement japonais, la plus grande réserve d'actifs de retraite du monde. Le Fond d'Investissement des Pensions du Gouvernement a acquis son nom en 2006 lors d'une réforme majeure de la gouvernance dont le but était d'augmenter la transparence et l'autonomie du fonds. Bien que la nouvelle structure de gouvernance se soit fortement améliorée, elle reste en deçà des meilleures pratiques internationales et par certains aspects ne satisfait pas à certains critères de base contenus dans les recommandations de l'OCDE, notamment les *Lignes directrices de l'OCDE sur la gouvernance des fonds de pension*.

Codes JEL: G18, G23, G28

Mots clés: fonds de pension, régimes publics de retraite, protection sociale, caisses de réserve, gestion de portefeuille, gouvernance

OPTIONS TO IMPROVE THE GOVERNANCE AND INVESTMENT OF JAPAN'S GOVERNMENT PENSION INVESTMENT FUND (GPIF)

by Fiona Stewart and Juan Yermo¹

Executive summary

Japan has a major asset to address the impact of population ageing on its public pension system in the form of the Government Pension Investment Fund (GPIF). The GPIF is the largest pension fund in the world at JPY140tn (USD 1.4tn), representing nearly one quarter of the country's GDP and three and a half years of annual public pension expenditure as of September 2009. The Japanese public pension reserve fund earned its name in 2006 as part of a major governance reform that aimed at increasing the transparency and autonomy of the fund. While much improved, the new governance structure still falls short of international best practices and in some aspects does not meet some of the basic criteria contained in OECD recommendations, in particular the *OECD Guidelines for Pension Fund Governance* (OECD 2009).²

The main concerns over the governance structure of the GPIF are the following:

- The GPIF does not appear to be a fully independent, segregated entity. The Ministry of Health, Labour, and Welfare (MHLW) takes on some functions of governing body of the reserve fund. It has some influence over the GPIF's staffing (a few GPIF employees are civil servants from the MHLW) and sets out medium-term goals for the fund. It is also unclear whether the Ministry also plays a role in the formulation and approval of the strategic asset allocation, a key responsibility

¹ Fiona Stewart and Juan Yermo are principal administrators in the Financial Affairs Division of the OECD's Directorate for Financial and Enterprise Affairs. Though drawing on OECD Council approved recommendations and other work supported by OECD committees, the views expressed herein are those of the authors and do not necessarily reflect those of the OECD or the government of its Member countries. In particular, the Japanese Government has refrained from making any comments on this paper because it is still considering the issues referred to herein. The authors are solely responsible for any errors.

² The Guidelines can be accessed at <http://www.oecd.org/dataoecd/18/52/34799965.pdf>. The analysis also makes references to the *OECD Guidelines on Pension Fund Asset Management* (OECD (2006), which can be accessed at <http://www.oecd.org/dataoecd/59/53/36316399.pdf>. The OECD governance and investment standards are also fully consistent with the ISSA Guidelines for the Investment of Social Security Funds developed by the International Social Security Association (ISSA 2005), which cover both governance and investment management issues and used the OECD guidelines as a blueprint.

that is in principle under the responsibility of the chairman of the GPIF. At least one aspect of the GPIF's investment policy, passive management, is determined by the MHLW.

- As an Independent Administrative Agency, the GPIF is subject to government wide restraints on operating costs, including controls on the fund's staff remuneration policy – however investment management costs are exempt. This may be creating a bias towards outsourcing, which is not necessarily in the best interests of the fund. Cost controls also explain the GPIF's relatively small staff.
- The GPIF has a Chairman, a Director (Chairman's aide/Counsellor) and two Auditors, which is in line with the Japanese legislation's requirements for Independent Administrative Agencies. However, such a structure is atypical for a pension fund, especially one of the size of the GPIF's. This legislative requirement impedes the clear separation of oversight and executive responsibilities between a Board of Directors on the one hand and a CEO (or/and CIO) on the other. Rather, all oversight and executive powers within the GPIF are effectively concentrated in one person, the Chairman.
- There are no specific written guidelines for the appointment of the chairman of the GPIF. Although the Chairman is required to have experience in economic and financial matters, it is not clear that there are any relevant criteria for the Director and Auditor. The selection process is not transparent, neither are the criteria and processes for removal.
- The GPIF has also established an investment committee of a suitable size (up to eleven members), with the requirement for financial and economic experience. A few are from academia and there are also two representatives each from labour and management. None of the members of the investment committee are full-time investment managers of the GPIF, which apparently results from the cost constraints imposed by the regulations of Independent Administrative Agencies.
- While there is a requirement for an annual independent audit and the GPIF itself has two internal auditors, there is no audit committee. It is not clear therefore how effectively internal control and audit issues are addressed. Risk management is not very developed either (there is no risk committee and it is not clear whether the risk management function is secured).
- There appears to be no requirement for the GPIF's Chairman to draft and publicly disclose the following documents: code of conduct, conflicts of interest rules, and statement of investment policy.
- There are also some specific issues with respect to the governance of the investment management process that call for review such as the current practice of setting a return target linked to wage growth for performance benchmarking purposes.

We suggest the following governance recommendations which would bring the GPIF further into line with OECD guidance and international good practice. Such governance changes would also be required before any restructuring of the investment strategy:

- Separate operational and oversight functions within the GPIF, establishing a Board of Directors and a separate executive team led by a CEO and CIO, who are selected by the Board following a hiring process based on transparent, professional (fit and proper) criteria.
- Grant budgetary and administrative autonomy to the GPIF, –including control over pay grades and personnel policy (separate from the civil service). The GPIF’s Board should establish its annual business plan and budget and submit it for approval by the Japanese government (or Diet).
- Members of the Board of Directors should be appointed by the MHLW, but possibly also by labour and employer associations. An additional control on the appointments may be introduced by requiring the ratification of the appointments by the Japanese Diet. The board should also include some independent experts, such as academics and independent consultants, without ties to the fund’s main stakeholders or the financial industry. Given that the GPIF is in effect the largest pension fund in the world, it should be possible to recruit global leaders in the pension field to this role.
- All board members should have some knowledge in financial and investment matters and should be subject to “fit-and-proper” requirements. There should also be an induction policy for new members and a training programme to ensure that the knowledge and skills set of the Board’s members is kept up to date.
- Transparent, formal appointment procedures should be set out for board members (independent selection committee and public hearings / approval by the MHLW or the Japanese Diet), along with criteria required to fulfill the role, fixed term appointments and clear guidelines for when/ how they may be removed.
- The responsibility of the government vs. GPIF should be clarified. Given its responsibility for the operation of the public pension system, the MHLW should establish the overall funding target of the GPIF (in consultation with the GPIF) and conduct an annual, oversight review of the organisation. The MHLW should also establish a long-term, investment performance goal of the fund consistent with the funding target and the actuarial valuations of the public pension plan.
- The GPIF’s board should alone set the investment policy for the fund, including the ongoing target rate of return, the risk tolerance for the fund and the strategic asset allocation for achieving these targets. The investment committee should be responsible for advising the board on passive vs. active investment and other aspects of the investment policy, selecting external managers, choosing specific assets, managing the tactical asset allocation around the strategic target and have day to day responsibility for the investments of the fund.

- With the help of the investment committee, the GPIF Board should draft and regularly review a detailed statement of investment policy which should be publicly disclosed. The investment strategy should also be reviewed if the investment target changes.
- The investment committee should be turned into an integral governance body of the GPIF and all members should be subject to strict requirements on investment knowledge and professional experience, covering academic as well as other relevant experience. A transparent appointment and dismissal process should be established.
- The investment committee should include some full-time staff of the GPIF such as the CEO, CIO and possibly other senior investment managers as well as the chair of the Board of Directors. External experts should be appointed to serve the committee on an ad-hoc basis. There is no particular reason to have labour or management representatives in the investment committee. The representation of these stakeholders should be transferred to the Board of Directors.
- Other governance bodies (e.g. audit committee, governance committee, risk-management committee) should be established.
- Risk management should be upgraded with greater focus given to external manager's own risk controls and outsourcing risks.
- The GPIF Board should report annually to the MHLW as well as to the Japanese Diet.
- The public disclosure of the GPIF should be improved - including publishing long-term investment returns as well as quarterly numbers, a detailed statement of investment policy, a code of conduct and a conflicts of interest policy.
- Some specific details of the governance of the investment management process also need to be reformed. In particular, the GPIF needs to establish a transparent, market-based, ongoing performance target and benchmark, referencing the long-term actuarial performance goal set by the MHLW and linking it clearly to the strategic investment allocation of the fund.

While the purpose of this report is not to provide specific recommendations on the design of the GPIF's investment policy, there are some issues that should be considered once the governance structure is reformed. These include the following:

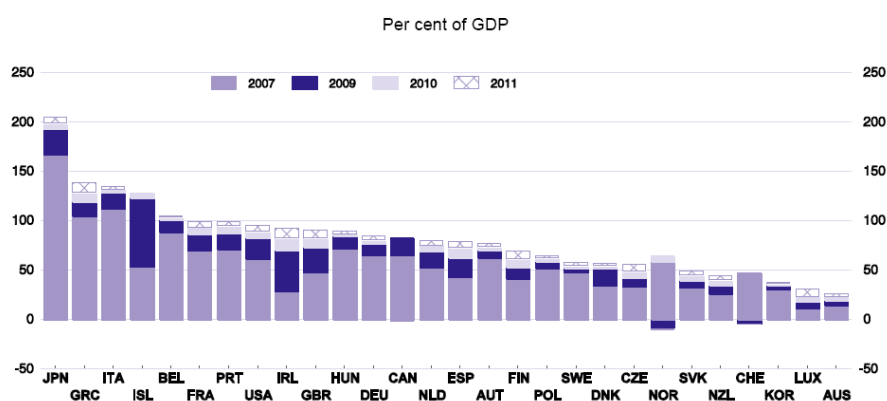
- The GPIF should consider whether the investment strategy as it stands provides sufficient diversification given the high level of exposure to Japanese government bonds. This issue is beyond the scope of this paper and should be considered carefully in the light of the growing debt burden of the Japanese government and the general risk apprehension of the Japanese population. Given the size of the fund, the macroeconomic effects of possible changes in the GPIF's investment strategy should also be carefully evaluated.

- The GPIF should consider whether the long-term performance goal of the fund may be better attained – while improving the fund’s diversification – by allocating a small amount of funds towards long-term, less liquid instruments, including foreign ones.
- The current ceiling set by the investment committee on investment in foreign securities (the portfolio invested in foreign bonds must be less than the portfolio invested in foreign equities which in turn must be less than the portfolio invested in domestic equities) should be justified on financial grounds taking into the account the fund’s performance target.
- The investment policy should consider the fund’s potential impact on the domestic economy and financial stability and it should integrate environmental, social and corporate governance (ESG) factors. The GPIF could become a signatory of the UN Principles of Responsible Investing.

I. Introduction

The challenges of an aging population and rising government debt levels are not unique to Tokyo – though these issues are particularly pressing for Japan vs. its OECD peers.³ Population ageing is most advanced in Japan and UN projections show that this is still likely to be the case in 50 years. Japan has also overtaken all other OECD countries in the level of gross debt to GDP. Pension obligations consequently represent a major percentage of the Japanese government’s long-term commitments.

Figure 1.15. Government debt heads higher



Source: OECD Economic Outlook 87 database.

The OECD supports the establishment of reserves to prefund social security benefits in order to help governments respond more effectively to the fiscal pressures from ageing populations (via tax smoothing and raising public savings thereby improving the overall debt position of the government). In addition, international diversification of the reserve fund’s assets can provide (long-term) exposure to other countries experiencing less of a demographic decline and faster growth rates.

³ Indeed the OECD has a more pessimistic debt outlook than the Japanese government – estimating 208% gross financial liabilities/ GDP in 2017 vs. the Reference Projection of 168%.

Japan is fortunate to have built up significant pension reserves in the previous decades – and indeed now has a major asset in the form of the Government Pension Investment Fund (GPIF) which represents the largest pension fund in the world at JPY140tn (USD 1.4tn) - a major tool for addressing the demographic and deficit challenges of the country. The fund represents nearly one quarter of the country's GDP and three and a half years of annual public pension expenditure.

Table 2. Size of public pension reserve fund markets in selected OECD countries, 2009

Type of fund	Country	Name of the fund or institution	Founded in	Assets		
				USD billions	% of GDP	% increase
Social Security Reserve Fund	Canada	Canadian Pension Plan	1997	108.6	8.5	13.8
	France (1)	AGIRC-ARRCO	n.d.	72.4	2.5	n.d.
	Japan (1)	Government Pension Investment Fund	2006	1 137.7	23.2	n.d.
	Korea	National Pension Fund	1988	217.8	26.1	17.9
	Mexico	IMSS Reserve	n.d.	3.6	0.3	3.3
	Poland	Demographic Reserve Fund	2002	2.3	0.5	64.4
	Portugal	Social Security Financial Stabilisation Fund	1989	13.1	5.7	12.8
	Spain	Social Security Reserve Fund	1997	83.4	5.7	4.9
	Sweden	National Pension Funds (AP1-AP4 and AP6)	2000	108.8	27.2	13.2
	United States	Social Security Trust Fund	1940	2 540.3	17.9	5.0
Sovereign Pension Reserve Fund	Australia	Future Fund	2006	51.6	5.9	11.0
	Belgium	<i>Zilverfonds</i>	2001	23.5	5.0	4.4
	France	<i>Fond de Réserve des Retraites (FRR)</i>	1999	46.3	1.7	20.6
	Ireland	National Pensions Reserve Fund	2000	31.0	13.7	38.5
	New Zealand (2)	New Zealand Superannuation Fund	2001	8.3	7.1	-6.7
	Norway (3)	Government Pension Fund - Norway	n.d.	19.0	5.0	32.9
Total selected OECD countries (4)				4 467.7	18.6	7.3

Source: OECD Global Pension Statistics.

How the GPIF is managed is therefore of key importance to the Japanese government and people –as well as for capital markets and companies both domestically in Japan and potentially overseas.

Yet the GPIF is at present being run as a low profile, low cost and seemingly low risk institution. Though reforms of recent years established the GPIF as an independent institution on paper, the governance structure of the fund is sub-optimal and does not conform to OECD recommendations and international good practice, leaving the fund exposed to greater risks than may seem apparent on the surface. As importantly, the current structure and management represent a major wasted opportunity for the Japanese government and society at large.

This paper aims to look at whether the GPIF conforms with OECD guidance and international good practice, and makes recommendations for improving the governance and thereby reducing the risk of the fund, along with suggestions for unlocking the potential of this unique institution.

II. The GPIF's Governance

Good governance is an important issue for any pension fund as it reduces risk⁴ and evidence increasingly suggests that it increases investment returns.⁵

Governance is even more important for public pension funds - including reserve funds. Ensuring good governance of reserve funds is essential to meet their goal of financing public pension systems. Given the size of reserve funds in many countries, their governance has also major implications for the behaviour of the financial system.

A particular concern in the governance of reserve funds is how to ensure sufficient independence from undue political interference as the government can be tempted to use the funds for other purposes than pension financing. Reserve funds are established by the government, which also selects at least some of the members of the governing body, and may influence its decisions, either directly (through regulations), or indirectly, through political influence on the fund's board members and managers.

There is also a large body of literature underlying the importance of governance for the performance of public pension funds⁶ – with evidence suggesting that, due to poor governance, the investment performance of public pension funds has been mixed, with many funds obtaining negative real rates of return over an extended period.

How can good governance be ensured? At a minimum, public pension reserve funds should be subject to similar governance and investment management standards as pension funds, following the *OECD Guidelines for Pension Fund Governance* (OECD 2009)⁷ and the *OECD Guidelines on Pension Fund Asset Management* (OECD (2006)).⁸ The OECD effectively address basic governance and investment

⁴ In terms of the GPIF, the risk of the fund lies with the ultimate principles or owners of fund - i.e. the Japanese people. This can manifest itself as requirement for higher contributions into Japanese public pension arrangements than anticipated, lower pension payments than anticipated or a combination of the two. Financial risks are not the only ones which the GPIF must control – there are also operational risks of managing such a large fund and reputational risk (i.e. the need to maintain public confidence).

⁵ See Ambachtsheer (2006). Using pension funds based in Australia, New Zealand, Canada the United States and Europe, the analysis in the paper is based on pension fund executives' own opinions of how well their governance is working as a proxy for good governance, with pension fund returns over a passive asset benchmark taken as a performance proxy. The conclusion is that "the 'poor-good' governance gap, as asserted by pension fund CEO's (or equivalents) themselves, has been 'worth' as much as 1-2% additional return per annum" – and the authors note that this is likely to be an underestimation.

⁶ See Impavido (2002), Impavido and Palacios (2000), and Unseem and Mitchell (2000)

⁷ The Guidelines can be accessed at <http://www.oecd.org/dataoecd/18/52/34799965.pdf>

⁸ The Guidelines can be accessed at <http://www.oecd.org/dataoecd/59/53/36316399.pdf>. The OECD governance and investment standards are also fully consistent with the ISSA Guidelines for the Investment of Social Security Funds developed by the International Social Security Association (ISSA 2005), which cover both governance and investment management issues and used the OECD guidelines as a blueprint.

management issues. However, in the case of reserve funds additional safeguards are needed to promote better protection from political manipulation of the funds. Internal and external governance mechanisms and investment controls can be put in place in order to isolate reserve funds effectively from undue political influence.

The following section of the paper will assess whether the GPIF is compliant with some of the key recommendations in the OECD guidance and international good practice.

1. Governing Body:

a) Autonomy

As the OECD guidelines point out, the governing body of the pension fund is the key body in governance terms. The governing body is the central strategic decision-making organ of a reserve fund. Its main function is approving the investment policy for the fund, and specifically, the strategic asset allocation. The governing body also monitors the executive and operational staff of the fund and is responsible for fulfilling the fund's mission and complying with regulations.

Given the critical importance of the governing body, it is understandable that efforts at insulating reserve funds from political risk have focused on it. The role of the governing body is even more important for public pension funds and especially for reserve funds as they are usually the single players in the sector and hence one cannot readily compare them against their national peers, as is often done with private pension funds.⁹ A strong, qualified board of directors, as far as removed as possible from political influence, is therefore an essential feature of a well-governed reserve fund.

Though the OECD recognize that the governing body of a reserve fund may be a government ministry, the board of the social security institution or the board of an entity established expressly for the purpose of investing the scheme's funds, the latter, segregated set-up is preferable as a protection against political interference, especially if a government ministry is responsible for administering the social security scheme. Ideally, reserve funds should be served operationally by an autonomous management entity, dedicated exclusively to the administration and investment of the reserve fund assets. Possible exceptions to this general recommendation are small reserve funds (for which separation may be costly) and funds that by law can only invest in domestic government bonds (for which a separate management entity would not be needed). Even in such cases, however, there should be a department in the government ministry or the social security institution exclusively dedicated to the reserve fund.

Such a segregated governance model of reserve funds (which operates in countries such as Canada, France, Ireland, New Zealand and Sweden) presents some important advantages over the integrated model where the fund is under the direct control of government or the social security institution:¹⁰

⁹ One can, however, compare reserve funds across countries, as is done in this paper.

¹⁰ One potential drawback of the segregated governance model is that investment management is separated from the actuarial and payments functions of the social security system. On the other hand, as the main goal of

- There is less scope for political interference in the management of the reserve fund. Under the segregated mode, key decisions, such as the strategic asset allocation are decided by an autonomous entity at arm's length from government and the social security institution;
- There is greater clarity in mandate and objectives, without any other policy goals than the investment of the reserve fund's assets. For example, under the segregated model, the governing body is not responsible for contributions and benefit payouts;
- There is greater transparency and accountability of a segregated fund's governing body. The focus on investment management raises the visibility of the board's action and allows an effective measurement of its performance;
- It is easier to attract qualified investment professionals than to a social security institution. An autonomous management entity may be able to apply a different salary scale than the one in place in the social security institution and may also be able to avoid many of the latter's bureaucratic procedures.

GPIF

In principle, Japan's reserve fund follows the preferred model of segregated governance. The GPIF is established as an Independent Administration Institution. However, its role is to administer the tasks based on the medium term objectives and plans instructed and approved by the Minister of Health and Welfare, including key strategic objectives such as the target rate of return¹¹ and a requirement to rely primarily on passive (index) funds to implement the investment strategy. Therefore the GPIF decision making is limited to what has been authorized by the Minister in charge – i.e. it is not a fully independent, segregated entity and therefore not in line with OECD recommendations or international good practice of its peers. The Ministry takes on some functions of governing body of the reserve fund and has some influence over its staffing. As of April 2010, 7 of the 75 staff of the GPIF were from the MHLW. It is also unclear whether the Ministry also plays a role in the formulation and approval of the strategic asset allocation, a key responsibility that is in principle under the responsibility of the chairman of the GPIF. At least one aspect of the GPIF's investment policy, passive management, is determined by the MHLW.

Given the size of the fund and its current investment policy (with an important allocation to assets other than Japanese government bonds), there would be merit in granting more autonomy to the GPIF, in terms of both decision-making responsibilities and budgetary control. Ideally, the Ministry should have a supervision role rather than requiring its approval for decisions taken by the GPIF. Following OECD

reserve funds is to help facilitate tax-smoothing over a relatively long time period, an independent governing body can focus on long-term investment objectives.

¹¹ In accordance with government instructions, the target, long-term rate of return should be sufficient to maintain a stable ratio of reserves to annual public pension expenditure. As a result, the GPIF has a long-term real rate of return target of 1.1% p.a. above the assumed rate of growth of wages (i.e. 2.2% p.a. real or 3.2% nominal based on current expectations). The 2009 OECD Economic Survey of Japan points out that the projections are sensitive to the economic and demographic assumptions and additional reforms may become necessary in the future if the assumptions are not met. The 2009 projection assumes a higher rate of return at 4.1% (compared to 3.2% in the 2004 projection) and a wage growth of 2.5% (compared with 2.1%), thus widening the gap between the return on investment and wages from 1.1% to 1.6%.

recommendations, the GPIF should be in charge of drafting and reviewing regularly – at least every three years - a detailed statement of investment policy.

Decisions of the GPIF are made by the GPIF Chairman, in consultation with a Chairman’s Aide (Counselor) and two Auditors (one of whom is from the MHLW), although there is no official Board of Directors. Policy making and operations are under the sole jurisdiction of the Chairman, which implies that the governance of the GPIF is not operating effectively and again that the GPIF is not fully independent. Moreover, the actual authority and responsibility of the senior staff are unclear (as is the relationship with the investment committee – see later discussion).

Table 2: Management entities and governing body of reserve funds

Country	Management Entity	Governing body
Canada	Canada Pension Plan (CPP) Investment Board (a public sector corporation)	Board of Directors of the CPP Investment Board
France	Pension Reserve Fund (FRR)	Supervisory Board of the FRR
Ireland	National Treasury Management Agency	National Pensions Reserve Fund Commission
Japan	Government Pension Investment Fund (GPIF)	Chairman of the GPIF and Ministry of Health, Labour and Welfare
Korea	Fund Management Centre of the National Pension Service (the country’s social security institution)	National Assembly
New Zealand	Guardians of New Zealand Superannuation (a public sector corporation)	Board of the Guardians of New Zealand Superannuation
Norway	Norges Bank Investment Management (an arm of the Central Bank) for the “Global” fund and “Folketrygdfondet” (National Insurance Fund) for the “Norway” fund	Norwegian parliament and Ministry of Finance
Sweden	AP Fonden	Board of Directors of the AP Fonden

The lack of a Board of Directors that provides independent, professional oversight is a shortcoming in the governance structure of the GPIF – a gap which cannot be filled by the Investment Advisory Committee (which has no authority).

The governance structure makes it more likely that the fund will stick to rules and will be affected by political considerations, stifling change and innovation. The governance structure of the fund may therefore encourage its low profile, seemingly low risk, conservative nature which may not be addressing risks fully and certainly means that the potential of the institution is under-utilized.

Another way in which this lack of independent governance may be hurting the fund is that costs are not independently controlled – though it should be noted that their absolute levels are relatively low (0.038% AUM). As an Independent Administrative Agency the GPIF decides on its budget but is subject to government wide restraints on operating costs – however investment management costs are exempt. This may be creating a bias towards outsourcing, which is not necessarily in the best interests of the fund. On the one hand some reserves funds (e.g. in Sweden) use external managers for at least part of the funds as

one way of isolating the funds from political pressure. On the other hand, the larger reserve funds (e.g. Norway, Canada) have the scale to build up significant in-house operations. Given the scale and high profile nature of the GPIF, it would be possible to set up a world class fund management operation in-house (taking away possible agency issues, oversight and control risks, or even potential corruption risks in dealing with outside fund managers). The GPIF employs 10 trust banks and 30 investment advisors to manage 70% of assets externally – which seems a large number for what is in principle a simple, largely passive investment strategy. Agency risks, cost control, operational risk and reputational risk may all be increased by this structure.

b) Membership+ Selection

As the ultimate authority with responsibility for the management of the reserve fund, the composition and functioning of the governing body are the first and main determinant of the fund's performance. An experienced, well-functioning board will ensure that proper monitoring, incentive and control mechanisms are put into place to achieve the fund's objectives.

The OECD governance guidelines note that the membership of the governing body of a pension fund should be subject to minimum suitability (or non-suitability) standards in order to ensure a high level of integrity, competence, expertise and professionalism in the governance of the pension fund. Furthermore, the governing body should collectively have the necessary skills and knowledge to oversee all the functions performed by a pension fund, and to monitor those delegates and advisors to whom such functions have been delegated. While it may not be necessary for all board members to be experts in finance, the board must collectively possess the necessary skills to carry out its oversight function effectively.

Special care needs to be taken with the selection and appointment of the board of reserve funds, given the potential for political interference and the appointment of directors to serve largely as representatives of specific stakeholders.¹² The role of independent directors appears to be even more needed than in private pension funds.

The size of the board is also important. Though it should reflect the nature and scope of the organization, if too large, efficient decision making can be impeded.

Board members should be appointed following a transparent selection and nomination process. While the government often appoints directors to represent non-government interests, it is likely that the influence that the government has on their nomination process seriously limits the ability of the appointed directors to independently execute their functions. One way to reduce the direct influence of government in the appointment of directors and reduce the scope for cronyism is to establish a nominating committee of experts (selected by the government) who in turn nominate the directors of the reserve fund following a transparent recruitment process. This appointment structure is followed by the Canadian and New Zealand reserve funds.

¹² Social security institutions usually have tripartite representation in their governing body (governments, employers and employees).

Termination clauses are also important to avoid the capricious dismissal of members of the governing body by government.

GPIF

The composition and selection of the board of the GPIF is not in line with OECD guidance or international good practice. Although the Chairman is required to have experience in economic and financial matters, it is not clear that there are any relevant criteria for the Chairman’s Aide (Counsellor) and the two Auditors.

The selection process is not transparent, neither are the criteria and processes for removal. An independent selection process (such as a selection board, parliamentary approval, public hearings) would be preferable. The size and reputation of the fund should allow the GPIF to attract world-class (international) talent.

Selection of the governing body of reserve funds

Country	Fit and Proper criteria	Nominations	Length of appointment	Removal
Canada	Directors are chosen based on financial experience and other criteria.	Directors are appointed by the Finance Minister from a list drawn by a nomination committee.	Directors have three-year terms for a maximum of three terms (9 year maximum).	Directors may only be removed for cause.
France	Two of the twenty members of the supervisory board must be individuals with recognized credentials in fields considered to be relevant to the FRR’s stated mission.	Members are appointed by parliament (2), the senate (2), various ministries (4), trade unions (5) and employer and self-employed associations (5).	Members that are not appointed by government authorities have six year terms.	
Ireland	Commissioners must have expertise and experience at senior level in any of the following areas: investment, economics, law, actuarial practice, civil service, trade union representation, etc. Civil servants cannot be Commissioners. A commissioner shall be disqualified from being a member of the Commission where he or she is bankrupt, is convicted of an offence involving fraud or dishonesty,	Commissioners are appointed by the Minister of Finance, except the CEO of the management entity, who is an exofficio member of the Commission.	All Commissioners other than the CEO of the management entity have five year terms, renewable for a second consecutive term.	A commissioner may be removed by the Minister of Finance if the member has become incapable through ill-health of performing his or her functions, or has committed stated misbehaviour, or his or her removal appears to the Minister to be necessary for the

	or is disqualified or restricted from being a director of any company.			effective performance by the Commission of its functions.
Japan	The Chairman and investment committee members must have experience in economic or financial matters.	The Chairman is appointed by the Ministry of Health, Labour, and Welfare.		
Korea	The national assembly is the main governing body.	Not applicable	Not applicable	Not applicable
New Zealand	All board members must have experience, training and expertise in investment management.	Board members are appointed by the Ministry of Finance via a nominating committee.	Board members are appointed for up to 5 years.	Board members can be dismissed for reasons that in the Minister's opinion justifies the removal.
Norway	The governing body is parliament and the ministry of finance.	Not applicable	Not applicable	Not applicable
Sweden	All board members are appointed on the basis of their expertise in asset management.	Directors are appointed by the government. Two are nominated by employee organisations and two by employer organisations. The Chairman and Deputy Chairman are appointed by the government from amongst the members who have not been nominated by the organisations.	Directors have 3 years terms.	There are no rules concerning the removal of board members. The government may remove a Director prior to the expiry of his term in office.

2. CIO + Investment Committee

Reserve funds, like pension funds, require a governance structure that ensures an appropriate division of operational and oversight responsibilities. This basic principle of governance is enshrined in both the *OECD's Guidelines on Pension Fund Governance* and *ISSA's Guidelines for the Investment of Social Security Funds*. Both set of guidelines contain similar criteria to implement this objective.

Yet even when reserve funds have achieved a clear oversight-executive separation on paper, in practice some boards are still excessively involved in investment micromanagement. This is often the case where they lack the necessary executive and operational support.

Good governance requires a clear assignment of responsibilities between the governing body and the fund's executive. The composition and organisational structure of the executive matters greatly for the successful deployment of a fund's resources. In particular, the separation of the role of chief executive and board chairman is essential in reserve funds because of the lack of a market mechanism or external supervisor that can ensure effective, ongoing monitoring of the reserve fund's executive. In investment

institutions, two key roles are those of the chief executive officer (CEO) and the chief investment officer (CIO). Many large pension funds have both of these functions, clearly separated from the board of directors, as well as most reserve funds served by autonomous management entities. For instance, the Canadian reserve fund (CPPIB) has a board of directors and an executive team led by the CEO and including also a CIO, CFO and COO.

To further aid and clarify the distinction between oversight and operational roles, an investment committee should be in place. Whereas the board has the responsibility for setting the broad investment strategy and strategic asset allocation, the investment committee is responsible for evaluating and taking decisions on various aspects of the day-to-day investment of the funds, including the selection and oversight of external managers. The investment committee plays a central role in most reserve funds. It advises the governing body on the investment policy and the fund's performance.

The governing body appoints the investment committee from among its own membership, investment officers and external, independent experts. Members of the investment committee need to be knowledgeable about investment matters. It is also important to have representatives of the governing body sitting in the investment committee in order to create an institutional link between the two bodies and ensure smooth communication. For example, it is common for the chairman of the governing body to be a member of the investment committee.

GPIF

The GPIF has a relatively small staff. As of April 2010, it had 75 employees, compared to, for example, the 566 employees at the Canadian reserve fund (CPPIB). The GPIF Chairman in principle has the triple role of board chairman, CEO and CIO. All these features of the fund's governance depart from what may be considered international good practice. The lack of a clear separation between operational and oversight roles within the fund is a major problem that goes against OECD recommendations. Ideally, the GPIF should have a Board of Directors and there should be a separate management team led by a CEO or equivalent top manager.

The GPIF has also established an investment committee of a suitable size (up to eleven members), with the requirement for financial and economic experience. As of June 2010, the committee consisted of ten members, three of whom were from academia, three from private companies and two from private think tanks. There is also a requirement to have two representatives each from labour and management. A better mix of the investment committee is recommended – again using the size and reputation of the fund to gain world-class talent. Representatives from labour and management would also fit best in a separate board of directors, rather than in the investment committee.

All members of the investment committee also need to be knowledgeable on investment matters and should be subject to strict “fit-and proper” requirements, including investment knowledge as well as professional experience, covering academic as well as other relevant experience. Such requirements do not appear to be in place currently.

None of the members of the investment committee are full-time investment managers of the GPIF, which apparently results from the cost constraints imposed by the regulations of Independent Administrative Agencies. Given the size and the responsibility of the GPIF it would be desirable for some

of the members of the investment committee to be full-time staff of the GPIF (in particular senior investment managers).

As with the governing board, an independent and transparent process of appointment of the members of the investment committee would be preferable.

As discussed, the not fully independent structure and nature of the fund may mean that there is a bias towards external fund management, which is not necessarily in the best interest of the fund.

The oversight, management and operational responsibilities of the GPIF are unclear. The Ministry appears to be involved in operational decisions (via required approval) rather than undertaking an oversight role, whilst the decision-making of the GPIF is not transparent (and is dominated by the Chairman – appointed by the Ministry), and its involvement in operational decisions vs. the investment committee is also unclear. It is not obvious that the investment committee has any real role, with the Chairman ultimately taking investment decisions (not necessarily based on the investment committee’s advice). Who sets the investment policy, who sets the strategic asset allocation, who appoints external managers and who is responsible for the day to day oversight of the investments needs clarifying.

3. Other Governance Mechanisms

The OECD guidelines note a series of other governance mechanisms which should be in place, such as:

- ***auditors, actuary, custodian:*** the governance structure of reserve funds (like that of pension funds) usually also includes three other bodies:
 - an independent auditor should be appointed to carry out an annual audit of the fund. Independent performance evaluations are associated with better investment policies. Internal and external governance and performance audits are essential to increase transparency in the operations of the fund and improve accountability. An internal audit committee should be formed with the responsibility for overseeing financial reporting, the external and internal audit, information systems and internal control policies. It is good practice for reserve funds to have an audit committee that meets regularly to assess the adequacy of systems of internal control, review the fund’s accounts and the external auditor’s report.
 - in the case of funds that are integrated in the social security institution an actuary would also need to be appointed to carry out the actuarial valuations of the system and analyse the implications of different investment strategies for the system’s financing;
 - in most instances, it is also a good practice to appoint a custodian who is in charge of the safekeeping of the assets. The appointment of an independent custodian can also ensure a better protection of the fund’s assets and serve as a check on asset manager transactions.

- **Risk-management systems:**¹³ risk-based (i.e. proportional) risk-management systems should be in place at reserve funds – including adequate control systems, IT, monitoring and external controls, as well as internal oversight mechanisms (separation of duties, checking etc.). According to the OECD guidelines for pension fund governance (again, in common with the ISSA guidelines), reserve funds should have appropriate control, communication and incentive mechanisms that encourage good decision-making, proper and timely execution.
- **Codes of conduct and conflicts of interest:** control systems should include a code of conduct and mechanisms to address conflict of interest situations (e.g. tight controls on members own investments, including having to report any attempted political interference in investment decisions). A code of conduct for directors, guidelines on conflicts of interest and clearly defined fiduciary duties need developing as either separate plan documents or merged in a comprehensive governance manual. A governance committee could be used to monitor the application of the code of conduct and conflicts of interest guidelines and conduct periodical governance assessments.
- **Disclosure:** transparency and regular review and assessment are essential parts of good governance. This is particularly important for reserve funds which may have a large impact on capital markets and the financial system, and as they do not have clear benchmarks versus which to be judged. Reserve funds should also be required to disclose publicly relevant information and should have procedures in place to address complaints from the general public. The likelihood of mismanagement or undue influence can be drastically reduced if the public is regularly informed about issues such as the governance structure, the financial situation and the performance of the governance framework as well as the financial performance of the fund.
 - A sound statement of investment policies should be produced and at the same time there should be a transparent process for disclosing to the public how the investment policy is being implemented and adhered to.¹⁴
 - Standardised valuation methods, following international best practices (such as the CFA Global Investment Performance Standards) are also necessary also allow these reserve funds to compare their performance against relevant market benchmarks and against their own target return. In addition to valuing assets at market prices, it is

¹³ For details see (Stewart 2010) See also OECD/ IOPS *Good Practices for Pension Funds' Risk Management Systems* (OECD 2010 - forthcoming)

¹⁴ The investment policy document should clearly express the desired asset mix necessary to match assets and liabilities. It could also describe the role and composition of the investment committee, how investments are recorded, both short and long-term performance measures, the universe of vehicles which can be used to meet these measures, risk tolerance and guidelines and the reporting, compliance structures and performance reviews. Above all long-term performance measures should be consistent with the long-term target funding ratio of the plan.

important that management fees are accurately measured. Where only some expenses are charged to the fund, the additional costs should be disclosed by the relevant body.

- Reserve funds should be subject to a strict disclosure policy, requiring them to make their annual report publicly available, containing its audited financial statements as well as information on asset allocation and performance.¹⁵
- Other documents that should be publicly disclosed include the independent audit and the code of conduct.
- Additional oversight may be exerted by relevant public entities (for example, the pension fund supervisory authority) and parliament, as the accountability of the governing body calls for regular reporting of its activities to the relevant government authority (as well as the public at large).

GPIF

The following considers whether the GPIF conforms with the above requirement:

- **Auditors, actuary, custodian:** though an independent audit is carried out, the GPIF has not established an internal audit committee - or indeed other sub-committees which make up a good governance structure (for instance, a governance committee, a risk-management committee). It is not clear that the custodial aspect of the fund is fully independent and therefore in conformity with OECD guidelines and international good practice.
- **Risk-management systems:** the GPIF is currently being run as a low risk fund – therefore it is not clear that a world-class risk-management system is in place. The GPIF does not appear to feel the need for sophisticated risk-management tools or real-time information systems. Again the issue of costs (not being independently set) may be part of the problem. Even with a basic investment structure, the fund would likely benefit from better risk-management analysis. The GPIF would then be able to assess whether it is considering the risks it is facing properly – not just investment risk but also administrative, operational risks, etc.
- **Codes of conduct and conflicts of interest:** codes of conduct are based on a duty of care and a duty of loyalty. Such duties are expressly mentioned in the Japanese reserve fund's statement of investment principles, but it is not clear that separate codes of conduct have been drawn up.¹⁶

¹⁵ One of the central pieces of disclosure is the annual report, which describes the fund's investment operations during the year and contains the financial statements and the independent auditor's certification. All reserve funds are required to publish an annual report and to disclose the following information: portfolio allocation, by broad asset classes; investment performance; operational expenses.

¹⁶ Some reserve funds pay their governing and other board members (often remunerated as civil servants). In other countries they serve on a voluntary basis. Given the size, and potential influence of the GPIF, it should be

- **Disclosure:** there is some disclosure from the GPIF (e.g. the GPIF must present its independently audited financial statements to the MOHLW for approval, and then the accounts are disclosed to the general public. The GPIF also discloses publicly on a quarterly basis the result and status of its investments) - but there is room for improvement. Rebuilding trust in the pension system in Japan is important (given the problems with records in previous years). Transparent disclosure from the reserve fund (and showing it is a globally leading institution) would provide an excellent way to achieve this.

III. Investment

This section will examine the investment strategy of GPIF and its compatibility with OECD guidance and international good practice. The aim of this paper is not to propose an investment strategy for the fund – a highly complex and expert undertaking. Rather, the risks which the current strategy represent will be highlighted and potential ways for reducing these and for unlocking the potential of the fund will be suggested.

a) Investment Policy

The OECD guidelines note that the governing body of the pension fund should set forth in a written statement and actively observe an overall investment policy, which established clear investment objectives (compatible with the characteristics of the fund). As a minimum, the policy should cover:

- The strategic asset allocation (main asset classes);
- The extent to which external managers may be used and how they are to be selected and monitored;
- To what extent and how active investment management will be pursued; and
- The criteria for assessing the performance of the reserve fund and the different portfolio components.

This is even more important for reserve funds. Reserve funds, like pension funds, require a clear mission statement and measurable objectives to enhance their efficient management and raise the accountability of the governing body. Reserve funds do not normally have national competitors or even peers, as is the case with pension funds. Hence, their performance (including not just investment performance but also their operational efficiency) can only be benchmarked against any initial objectives set or, as far as relevant, against foreign reserve funds. Reserve funds support pension systems that do not have a full-funding goal in mind. Hence, investment objectives may not be readily established with regards to liabilities, time horizon or risk aversion. Reserve funds should have clear mandates and specific measurable objectives, such as funding ratio and investment return targets. The performance of the board should be measured against these objectives.

an honour to sit on the board, and members should not need to be paid (which helps conflicts of interest and gets away from civil service pay restrictions)

The setting of restrictions on broad asset classes should be left to the board of the reserve fund as part of the design of the investment policy.

GPIF

The GPIF has a clear mandate, which is to invest the assets so as to contribute to the long-term financing of public pension expenditures. The pension laws state that asset management should be ‘safe and efficient from a long term view’. The fund also has a long-term performance goal which is set by the Ministry of Health and Welfare and written into the fund’s medium-term goal. The target, long-term rate of return should be sufficient to maintain a stable ratio of reserves to annual public pension expenditure. As a result, the GPIF has a long-term real rate of return target of 1.1% p.a. above the assumed rate of growth of wages (i.e. 2.2% p.a. real or 3.2% nominal based on current assumptions).¹⁷

While actuarially speaking, such a long-term goal makes sense, from the perspective of an investment manager such a target needs to be translated into returns that can be obtained from market instruments. The GPIF cannot be evaluated for missing a target that is ultimately outside its control (wage growth). The GPIF is the only main public pension reserve fund in the world that has a performance target that is built on non-market instruments. In order to ensure an effective and transparent evaluation of the GPIF and its board, there should also be a market-based benchmark against which the GPIF’s performance can be assessed in a transparent and ongoing manner.

There appears to be no requirement for the GPIF to draft a detailed written statement of investment policy, as recommended by the OECD. It is also unclear whether the investment policy of the GPIF is set by the fund’s governing body or whether the governing body recommends the policy which is then approved and actually set by the MHLW — i.e. true independence (as recognized by OECD standards and international good practice) is not being met.

The statement of investment policy should clearly distinguish between the long-term target rate of return and the expected return – and hence the benchmark - from the chosen asset allocation. Such a statement, which should be publicly disclosed, should also lay out the investment beliefs underlying the chosen investment policy, the extent to which external managers will be used and how they will be selected and assessed, as well as the methods for performance evaluation, among other issues.

Costs are also not mentioned in the GPIF investment policy. The GPIF does use its scale to ensure that it is a low cost operation (it employed only 75 staff as of 2010, and paid external investment fees of 0.02% of assets under management) – but there is a danger that the GPIF is too focused on cost control (as discussed previously, due to its non-autonomous independent structure) possibly at the expense of returns. Upgrading risk-control and asset management capabilities may be seen as an investment rather than an

¹⁷ The 2009 OECD Economic Survey of Japan points out that the projections are sensitive to the economic and demographic assumptions and additional reforms may become necessary in the future if the assumptions are not met. The 2009 projection assumes a higher rate of return at 4.1% (compared to 3.2% in the 2004 projection) and a wage growth of 2.5% (compared with 2.1%), thus widening the gap between the return on investment and wages from 1.1% to 1.6%.

expense which could generate potential returns. The investment mandate, as well as the organisation and governance structure chosen for the GPIF, drives it towards a cost and risk minimizing culture.

Table 4. Total operating costs as a % of assets under management

Country	2007	2008	2009
Australia	0.03	0.07	0.18
Belgium	0.00	0.00	0.00
Canada	0.13	0.17	0.19
France - FRR	0.17	0.19	0.16
Mexico	0.04	0.03	0.03
Norway	0.05	0.09	0.09
New Zealand	1.04	0.64	0.57
Poland	0.04	0.01	0.02
Portugal	0.08	0.06	0.06
Sweden - AP3	0.13	0.14	0.17
United States	0.25	0.24	0.24

Source: OECD Global Pension Statistics.

Six of the eight reserve funds surveyed in the OECD 2008 report are also signatories of the UNEP FI's Principles of Responsible Investment (Canada, France, Ireland, New Zealand, Norway and Sweden). The GPIF may therefore be out of step with its international peers in this area.

b) Strategic Asset Allocation

OECD guidelines note that the strategic asset allocation of a pension fund should be put in place to deliver the investment objectives of the fund. The asset allocation should be set in the statement of investment policy and there should be a process for a regular review of that policy, at least every three years.

OECD reserve funds tend to have a high exposure to equity and other asset classes in the higher risk-return spectrum, including in some cases real estate, private equity, hedge funds, commodities, and other alternative investments. In countries like Australia, Canada, France, Ireland, New Zealand, and Norway reserve funds had over 50% of their portfolios in such asset classes as of December 2009. They are also increasingly investing overseas. For instance, as of end 2009, reserve funds in New Zealand, Sweden, France, Portugal, and Canada had over 70% of their equity portfolios invested abroad.

GPIF

It is interesting to note that although the long-term rate of return for the fund was adjusted from 3.2% to 4.1% there has been no change in the GPIF's strategic asset allocation because the investment target was unchanged as a result. Again the independence of the organization may be an issue (currently to change the target portfolio it is necessary to change the medium term plan which requires the approval of the MHLW and the MOF).

At present, 67% of the Fund is allocated to domestic bonds, 11% to domestic equity, 8% to foreign bonds, 9% to foreign equities and 5% to short-term liquidity, making it one of the more conservative of the

OECD reserve funds. The OECD's 2009 Economic Survey of Japan notes that it is questionable whether the current portfolio can generate returns consistent with the GPIF's projection.

The strategic asset allocation of the fund also does not seem to have been set with any consideration for the liabilities of the public pension system – which the OECD recognizes as important in developing investment strategies and fund objectives.¹⁸ The GPIF could therefore be exposed to unrealized duration risk and asset-liability mismatch.

c) Prudent Person – diversification + risk management

The OECD guidelines note that the approach for achieving the investment objectives should satisfy the prudent person standard, taking into account the need for proper diversification and risk management etc.

The reserve funds usually face additional restrictions intended to ensure diversification or to avoid direct control of corporations.

GPIF

The Japanese GPIF's investments are mainly restricted to domestic listed bonds and equities – this being the outcome of the medium term investment plan developed by the GPIF and approved by the Ministry of Health, Labour and Welfare. The investment policy excludes any allocation to alternative investments and allows the use of derivatives for hedging purposes only.¹⁹ The fund's investment committee has also established additional investment limitations (the portfolio invested in foreign bonds must be less than the portfolio invested in foreign equities which in turn must be less than the portfolio invested in domestic equities). There is little apparent justification for such a rule, which is unique among OECD reserve funds.

The Japanese GPIF's investment policy also sets a ceiling of 5% of its assets in securities issued by a single company and it limits its ownership of a given company to 5% of the firm's equity – which is generally in line with its peers and OECD practice – but could provide a practical constraint given the size of the fund (i.e. forcing it to make many investments for a small % of the AUM). This may also prevent private equity investments. The GPIF is also not expected to exercise directly shareholder rights but may do so only via the private financial institutions to whom investment is entrusted.

¹⁸ Mitchell et al (2008), in their analysis of pension reserve funds, note that: "The important lesson which emerges from these analyses is that investment policies which fail to take into account the payout paths can be misleading and potentially quite suboptimal. Therefore the lesson is that, in addition to paying attention to the efficient risk-return wealth frontier, fund managers should also take into account the ability of the fund to meet other objectives (e.g. not raising taxes too sharply on any given generation in event of a revenue shortfall.)"

¹⁹ Indirect investment in alternatives is allowed via trust contracts with financial institutions, etc. - though currently none are undertaken and would require approval from the MHLW in case such investment would go beyond the basic portfolio, which will require the revision of the mid-term plan.

The other key question is whether the target investment portfolio as it stands provides sufficient diversification given the high level of exposure to Japanese government bonds. This issue is beyond the scope of this paper and should be considered carefully in the light of the growing debt burden of the Japanese government and the general risk apprehension of the Japanese population. Given the size of the fund, the financial market effects of possible changes in the GPIF's investment strategy should also be carefully evaluated.

Where the GPIF clearly falls short is in terms of risk control. Investment returns may be targeted but there is no mention of within what risk parameter. The derivation of the Basic Portfolio seems to define how much investment risk GPIF should undertake (active / passive split less than 30:70). Its more sophisticated peers (e.g. the CPPIB in Canada) work to maximize the operation's risk budget. The GPIF does not seem to have any mechanism for even trying to generate additional returns (i.e. is not using its scale and long-term nature). Given that risk control is not considered, it may be assumed that the GPIF believes it is a low risk fund and consequently may not be examining its risks adequately. Is the GPIF really considering the risk which its huge holding of JGBs represents (which the OECD considers real given the rising level of public sector debt – even with the country's strong 'home bias' and domestic funding ability),²⁰ or is it just assuming that this is a low risk portfolio?

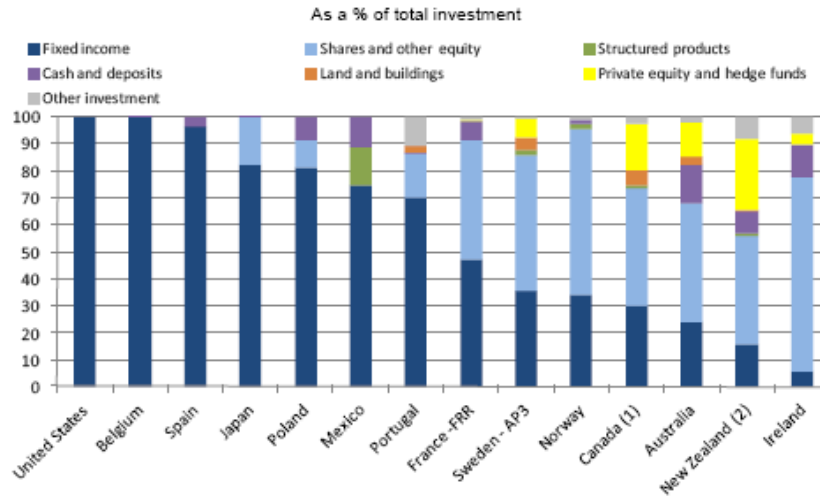
When weighing the pros and cons of different investment strategies, the GPIF could look at the experience of some of the older reserve funds which started operations with conservative portfolios, invested mainly or solely in fixed income securities or loans to public entities (e.g. Canada, Korea and Norway), but have gradually moved to more aggressive investment policies. The more recent funds (France, Ireland, New Zealand and Sweden) have all started with diversified portfolios that included at least a sizeable allocation to equities.

Though some of these funds were hit by the financial crisis in 2008, most recovered almost all of the losses in 2009 (see Figure 11 and Table 3²¹), and none was forced to carry out a major change in its investment strategy (with the exception of the Irish fund which has changed its investments in order to help recapitalize two Irish banks). Their experience shows that it is possible to obtain public approval of a higher risk – return investment strategy as long as it is adequately explained and justified.

²⁰ From 2009 Economic Survey Japan: looking ahead, the normalisation of financial conditions and a recovery in loan demand are likely to involve a general increase in long-term interest rates. Assuming a rise in Japan's long-term interest rate to 2.2% by the end of 2010, the OECD projects that gross public debt will reach 200% of GDP (100% for net debt, which would also be the highest in the OECD area). The rising level of debt increases the risk of a more significant increase in interest rates in coming years. In Japan, the outlook also depends in part on whether the factors that have reduced rates and kept them at a relatively low level in recent years will remain in place. A weakening home bias and a decline in financial institutions' purchases of government bonds could contribute to a rise in interest rates. The risk of increasing interest rates going forward lends urgency to Japan's efforts to overcome its budget deficit problem.

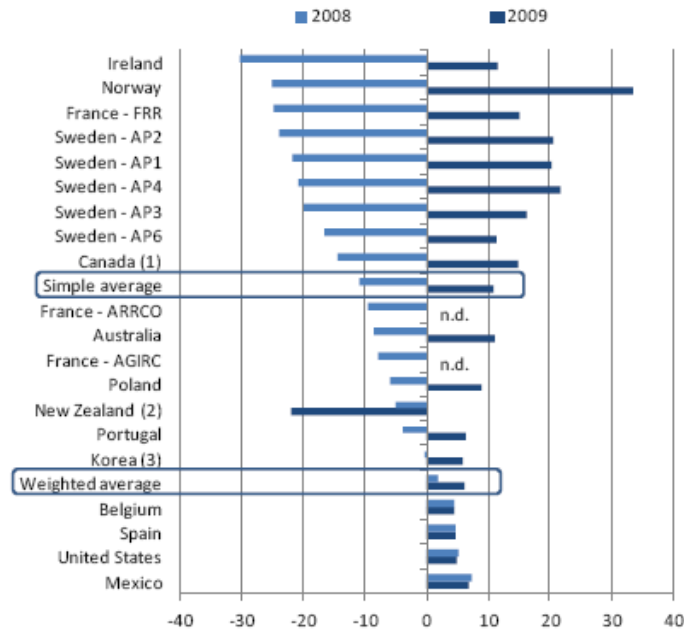
²¹ For countries that have longer data series, performance figures look somewhat brighter. For instance, over the last 10 years, the IMSS reserve in Mexico had an average nominal return of 8.8% annually; the Polish Demographic Reserve Fund's return was 8.5%; and the Government pension fund in Norway's was 6.8%.

Figure 12. Asset allocation of public pension reserve funds in selected OECD countries, 2009



Source: OECD Global Pension Statistics.

Figure 11. Public pension reserve funds' nominal net investment returns in selected OECD countries, 2008-2009 (%)



Source: OECD Global Pension Statistics.

Table 3. Nominal and real average annual PPRF returns in selected OECD countries over 2005-2009 (%)

Country	5-year average return	
	Nominal	Real
Belgium	4.4	2.2
Canada	5.7	3.8
France - FRR	2.5	0.9
Ireland	1.5	-0.6
Korea	4.7	1.7
Mexico	7.5	3.0
Norway	5.9	3.7
New Zealand	2.9	-0.1
Poland	6.9	4.0
Portugal	3.6	1.7
Spain	4.6	1.9
Sweden - AP1	4.8	3.3
Sweden - AP2	5.1	3.6
Sweden - AP3	4.8	3.3
Sweden - AP4	5.0	3.5
Sweden - AP6	5.6	4.1
United States	5.2	2.6

Source: OECD Global Pension Statistics.

Some further diversification of the GPIF should at least be considered. As Mitchell et al (2008) summarize: “As nations grow increasingly aware of obligations in the form of promises to their aging societies, this too prompts the need for more sophistication with regard to trading off equity premium on a global scale vs. the shortfall risk of a system running out of money. In sum, publicly managed fund fiduciaries must become increasingly aware of the rationales for better investment performance, the value of international diversification, and the opportunity costs of more aggressive investment.”²²

The GPIF and the MHLW should fully consider whether the fund’s portfolio is really as low risk as they it seemingly think, and whether the scale and long-term nature of the fund would allow it to invest in longer term, lower liquidity asses (such as infrastructure and private equity) which could generate low correlated returns. The GPFI could use the size of the fund as an advantage (e.g. even a 1% shift in its portfolio represents a large absolute amount of assets), having the capacity to build up such expertise in-house, allowing the GPFI to access assets with a liquidity premium.^{23 24}

²² Mitchell et al (2008) note that a 1% increase in returns from 3% to 4% could expand the GPIF final reserves by 11x as of 2100

²³ Usuki (2002) also makes the point that Japanese households have a low exposure to risky assets, so that the GPIF could represent an efficient, collective mechanism for gaining such exposure and increasing scare risk capital in the country (NB the opposite argument can be posed in relation to the Social Security Fund in the USA).

²⁴ “A recent study of Canadian pension funds found hat greater reliance on in-house investment management has brought about stronger performance. In the past decade, 9 Canadian public sector pension funds returned an average of 5.5% per annum while their 8 largest US counterparts – which employ outside managers more extensively – gained 3.2% annually.” See (Wong 2010).

Finally, this diversification could have a benefit over and above simply delivering higher performance. The GPIF has the capacity to become an internationally recognized, globally leading investment institution. Taking a truly long-term approach to investment (e.g. releasing long-term performance number rather than just quarterly data) could have a profound impact on the investment community in Japan, and indeed worldwide. This could also help to develop Tokyo as a centre of excellence in portfolio management, leading to the creation of a group of investment professionals who can compete with best in the world in such globally developing areas as private equity investing, infrastructure investing, emerging markets.²⁵

The OECD's work on corporate governance argues that there is a growing global consensus that global capitalist structure which includes knowledgeable, properly motivated institutional owners would reduce agency related frictions in the capitalist system.²⁶ Independent, high performance national reserve funds are ideally suited to play such a role and indeed are already doing so in other countries. A redefined and restructured GPIF would accelerate this process for the benefit of all.

IV. Conclusion

Though the GPIF was deliberately set up to manage the transition from investing Japan's pension reserve funds in public projects via government agencies to a more independent, financial return based investment structure (i.e. on a more politically independent basis), the governance structure of the fund falls short of international best practice and may be constraining the performance of the fund.

The GPIF conforms with some of the OECD's governance and risk-management guidelines, but it falls short in terms of the key recommendations for any reserve fund, that it should be truly autonomous and independent from political influence, with a clear separation of oversight and operational roles, and appropriate expertise on the board, committees, and management.

Unlike in other countries where this is the case, this does not mean that the fund is being used for political ends and aims other than to fund future pension obligations. Indeed, the GPIF was set up in recent years precisely in order to focus its objectives and as the previous aim of using pension reserves to fund economic and infrastructure development within the country were largely achieved.

Rather the issue is that the GPIF has been turned into a low-profile, seemingly low risk, low cost, limited return organization.

²⁵ NB, although the OECD does not directly promote socially responsible investing (SRI) investing, such a stance could help the Japanese government meet its targets for increased overseas investment in regions such as Africa.

²⁶ See OECD report on '*Corporate Governance Lessons from the Financial Crisis*'
<http://www.oecd.org/dataoecd/32/1/42229620.pdf>

As discussed, the risk-management of the fund may not therefore be up to international good practice and, as importantly, this political oversight is imposing a structure on the fund which means it may be wasting potential investment opportunities.

We suggest the following governance recommendations which would bring the GPIF into line with OECD guidance and international good practice. Such governance changes would also be required before any restructuring of the investment strategy.

- Separate operational and oversight functions within the GPIF, establishing a Board of Directors and a separate executive team led by a CEO and CIO, who are selected by the Board following a hiring process based on transparent, professional (fit and proper) criteria.
- Grant budgetary and administrative autonomy to the GPIF, –including control over pay grades and personnel policy (separate from the civil service). The GPIF’s Board should establish its annual business plan and budget and submit it for approval by the Japanese government (or Diet).
- Members of the Board of Directors should be appointed by the MHLW, but possibly also by labour and employer associations. An additional control on the appointments may be introduced by requiring the ratification of the appointments by the Japanese Diet. The board should also include some independent experts, such as academics and independent consultants, without ties to the fund’s main stakeholders or the financial industry. Given that the GPIF is in effect the largest pension fund in the world, it should be possible to recruit global leaders in the pension field to this role.
- All board members should have some knowledge in financial and investment matters and should be subject to “fit-and-proper” requirements. There should also be an induction policy for new members and a training programme to ensure that the knowledge and skills set of the Board’s members is kept up to date.
- Transparent, formal appointment procedures should be set out for board members (independent selection committee and public hearings / approval by the MHLW or the Japanese Diet), along with criteria required to fulfill the role, fixed term appointments and clear guidelines for when/ how they may be removed.
- The responsibility of the government vs. GPIF should be clarified. Given its responsibility for the operation of the public pension system, the MHLW should establish the overall funding target of the GPIF (in consultation with the GPIF) and conduct an annual, oversight review of the organisation. The MHLW should also establish a long-term, investment performance goal of the fund consistent with the funding target and the actuarial valuations of the public pension plan.
- The GPIF’s board should alone set the investment policy for the fund, including the ongoing target rate of return, the risk tolerance for the fund and the strategic asset allocation for achieving these targets. The investment committee should be responsible for advising the

board on passive vs. active investment and other aspects of the investment policy, selecting external managers, choosing specific assets, managing the tactical asset allocation around the strategic target and have day to day responsibility for the investments of the fund.

- With the help of the investment committee, the GPIF Board should draft and regularly review a detailed statement of investment policy which should be publicly disclosed.
- The investment committee should be turned into an integral governance body of the GPIF and all members should be subject to strict requirements on investment knowledge and professional experience, covering academic as well as other relevant experience. A transparent appointment and dismissal process should be established.
- The investment committee should include some full-time staff of the GPIF such as the CEO, CIO and possibly other senior investment managers as well as the chair of the Board of Directors. External experts should be appointed to serve the committee on an ad-hoc basis. There is no particular reason to have labour or management representatives in the investment committee. The representation of these stakeholders should be transferred to the Board of Directors.
- Other governance bodies (e.g. audit committee, governance committee, risk-management committee) should be established.
- Risk management should be upgraded with greater focus given to external manager's own risk controls and outsourcing risks.
- The GPIF Board should report annually to the MHLW as well as to the Japanese Diet.
- The public disclosure of the GPIF should be improved - including publishing long-term investment returns as well as quarterly numbers, a detailed statement of investment policy, a code of conduct and a conflicts of interest policy.
- Some specific details of the governance of the investment management process also need to be reformed. In particular, the GPIF needs to establish a transparent, market-based, ongoing performance target and benchmark, referencing the long-term actuarial performance goal set by the MHLW and linking it clearly to the strategic investment allocation of the fund.

While the purpose of this report is not to provide specific recommendations on the design of the GPIF's investment policy, there are some issues that should be considered once the governance structure is reformed. These include the following:

- The GPIF should consider whether the investment strategy as it stands provides sufficient diversification given the high level of exposure to Japanese government bonds. This issue is beyond the scope of this paper and should be considered carefully in the light of the growing debt burden of the Japanese government and the general risk apprehension of the Japanese population.

Given the size of the fund, the macroeconomic effects of possible changes in the GPIF's investment strategy should also be carefully evaluated.

- The GPIF should consider whether the long-term performance goal of the fund may be better attained – while improving the fund's diversification – by allocating a small amount of funds towards long-term, less liquid instruments, including foreign ones.
- The current ceiling set by the investment committee on investment in foreign securities (the portfolio invested in foreign bonds must be less than the portfolio invested in foreign equities which in turn must be less than the portfolio invested in domestic equities) should be justified on financial grounds taking into the account the fund's performance target.
- The investment policy should consider the fund's potential impact on the domestic economy and financial stability and it should integrate environmental, social and corporate governance (ESG) factors. The GPIF could become a signatory of the UN Principles of Responsible Investing.

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