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Funding Unfunded Pensions: Governance and Investments of Asian Reserve Funds

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Funding Unfunded Pensions: Governance and Investments of Asian Reserve Funds

Critical Issues

Many countries around the world have introduced pension reserve funds to fund parts of future liabilities in order to cope with the adverse effects of population ageing on public pension systems.

The pension reserve funds in Asia have, and will continue to accumulate huge amounts of assets. This paper investigates the four biggest reserve funds in Asia, which together have aggregate assets of EUR 766 billion under management, putting them among the biggest pension funds worldwide.

While pension reserve funds traditionally invested conservatively and were subject to political control, there is substantial change in the governance structures and investment policies of the Asian funds. Three key trends can be observed:

- Pronounced return orientation in the management of these funds has taken root, resulting in a retreat from public project financing
- Governance structures of Asian reserve funds are becoming more professional through board composition reforms and increasing independence of the reserve funds from government
- Outsourcing to private asset managers has risen considerably with the main motivation and consequence being an ongoing diversification of investments

The size of the Asian reserve funds means their investment strategy has substantial effects on the sustainability of national pension systems, the domestic economy and international financial markets.

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Introduction

There is an increasing trend in many countries around the world to build an additional element into their pension systems, namely pension reserve funds (also known as sovereign pension or demography funds). The main aim is to partially fund the liabilities of existing pay-as-you-go systems to cushion the future impact ageing societies will have on unfunded public pension systems. In this way, these funds can contribute to a higher sustainability of public pensions and avoid skyrocketing pension contributions for future employees. Pension reserve funds can differ in many dimensions, but they have an important influence on global financial markets and national economies. Their importance is illustrated by the fact that three of the world's four biggest pension funds are pension reserve funds.¹

This paper focuses on the Asian pension reserve funds in Japan, South Korea, Australia, and China, the four biggest reserve funds in the region. The Japanese and South Korean funds are among the biggest worldwide and are quite mature, while their Australian and Chinese counterparts have only been recently established. Despite differ-

ences in maturity, all four funds show striking similarities in terms of governance structures and investment policies. The key trends are a:

- Substantial increase in the return orientation of these funds, coupled with a retreat from public project financing
- Reform of board structures and compositions with a view to professionalise management, accompanied by an increasing independence of reserve funds from government
- Considerable rise of outsourcing to private asset managers, with the main motivation being to diversify investments

This paper first deals with the reasons why countries introduced pension reserve funds, then classifies the pension reserve funds and explains the traditional ways of managing these reserves before analysing recent trends in governance and investing. The last part describes the design, governance and investment policies of pension reserve funds in Japan, South Korea, Australia and China.

1 Pension reserve funds should not be confused with sovereign-wealth funds. The capital of sovereign-wealth funds comes from current account surpluses and resulting foreign exchange reserves, which are then reinvested.

The Rationale for Pension Reserve Funds

The impact of ageing on public pay-as-you-go systems is one of the main motivations for establishing pension reserve funds. In pay-as-you-go systems, the first pension pillar in most countries of the world, pension contributions of current employees are used to finance pension benefits of current retirees. Ageing populations imply that there will be fewer employees in the future, but more retirees. This means that, if the living standard of retirees is to be preserved, contributions to the pension system must rise substantially. If contributions remain constant, then pension payments to retirees must decrease. It has to be kept in mind that pension payments are already one of the biggest items in national budgets and that they will grow substantially. The scope of the problem can be illustrated by the concept of implicit pension debt, a measure for a country's future pension obligations or pension promises. This estimate aims to convert future streams of benefits into a current debt equivalent. For example, World Bank calculations show that China's implicit pension

debt amounted to 141% of GDP in 2001 for a projected period of 75 years (Sin 2005).

There are several reform options, such as providing greater weight to occupational and private pensions in old-age provision and cutting back public pension benefits. A measure that directly addresses the problems of pay-as-you-go systems is the establishment of pension reserve funds. Pension reserve funds pre-fund a part of future pension payments of the pay-as-you-go systems. This supports the working of the pay-as-you-go systems by smoothing the future costs of an older generation by limiting otherwise necessary future contribution hikes. Put differently, at the time when the ratio between employees and pensioners becomes unfavourable, the pension system can draw on accumulated capital to pay benefits instead of being purely dependent on contributions. In this sense, pension reserve funds act as a buffer against the adverse impact of ageing societies on public pensions.

The Financing of Pension Reserve Funds

This buffer function is central to dedicated pension reserve funds. Another type of reserve funds are those used for precautionary purposes, where some reserves are maintained to bolster the impact of the business cycle on the scheme balance. However, these funds only build up minor reserves. They are not designed for long-term purposes and do not accumulate long-term capital to disburden the pay-as-you-go system.

The main difference between long-term-oriented pension reserve funds relates to their funding. Pension reserve funds can be established intentionally as a means to cope with demographic change. This is the case

for the Chinese Social Security Fund and the Norwegian Government Pension Fund. These dedicated funds, which could be called strategic reserve funds, can be financed from various sources external to the pension system, such as privatisation proceeds, general budget surpluses or oil revenues. Hence, their main characteristic is that governments take countermeasures against foreseeable financing problems of public pension systems by earmarking funds from other sources to partially fund the pension systems in place.

A second type of long-term reserve fund emerges as a by-product of the operation of

the pension system in place. When contributions to the pay-as-you-go system are higher than the payouts, the surplus can be used to safeguard the pension system in the future. This is often the case in relatively young pay-as-you-go systems, like in South Korea, but also in established systems like Japan. The South Korean pay-as-you-go system was introduced in 1988, but the minimum membership period for pension benefits is 20 years, so that the system could accumulate all the contributions over this period and invest them in the National Pension Fund.

Both types of reserve funds have the same effect, namely to fund a part of future liabilities.

The only difference is that capital accumulated from the operation of the pension system itself can be considered a part of the social security system, while in the case of fiscal transfers the managing institutions are separated from the social security system. Another difference is that reserve funds, fed by fiscal transfers, are often not allowed to make payouts in the near or medium future (OECD 2007a). However, the distinction based on belonging to the social security system becomes blurred as reserve funds funded by contributions are increasingly established as independent entities, a topic analysed later. (Table 1)

Traditional Management of Reserve Funds

Pension reserve funds have often been criticised for their poor investment performance. This performance is perceived to stem from political influence on investment policies (Vittas, Impavido, O'Connor 2008). There is one crucial difference between pension reserve funds and other pension funds, namely that the government or a government-affiliated managing institution has control over the capital (Yermo 2008). This naturally makes it tempting for governments to utilise

the assets for political or other ends not directly related to financial performance.

As a result, the key issue regarding investments of pension reserve funds is the investment philosophy and the question: Should pension reserve funds be focused solely on maximising returns for the beneficiaries or should they promote “public” purposes as well? Traditionally, the pursuit of public purposes was stressed, often at the expense of

Table 1 Types of pension reserve funds

	Surplus from contributions over payouts	Surplus from fiscal transfers
Short-term impact	Precautionary Fund	Precautionary Fund
Long-term impact	Pension Reserve Fund (Japan, South Korea)	Strategic Pension Reserve Fund (Australia, China)

returns. Many pension reserve funds, as well as other public pension funds, have been forced to invest in low-yielding government projects. For example, as in Japan and South Korea, in housing loans or infrastructure, or generally in “economically-targeted investments” in the interest of economic development. There is also a danger that pension reserve funds loan to government at below market rates or have to confine investments to the domestic markets, which generates excessive country-specific risk (Weaver 2003). Besides, pension reserves can be used as a way of deficit financing for government, if domestic bond investments dominate. As a result, the general suspicion is that public reserve funds generate below-market returns because of political influence, which prevents them from maximising long-term returns.

However, financial market investments of reserve funds are complex. The main reason is that due to their sheer size, they can move the markets. If public reserve funds directly invest assets to a substantial degree in domestic equities, they would significantly influence share prices. They would also become important company owners. In this way, the government would become deeply involved in the corporate governance of those firms and conflicts of interest would arise. The fact that reserve funds are government or government-affiliated institutions also complicates direct foreign investments. If the reserve funds invested directly in foreign firms, a political backlash in the respective countries would be likely, as has been recently the case with the investments of sovereign-wealth funds from emerging economies in Western companies in the wake of the subprime crisis.

Trends in Asian Reserve Funds

At the same time, demographic developments require investments in higher-yielding assets. Given the unfavourable proportion of contributors and beneficiaries in the future, the capital of reserve funds is an important factor to smooth contributions. The more efficient the risk-return profile, the more disburdened the public pension systems. This implies diversification of assets between asset classes and internationally.

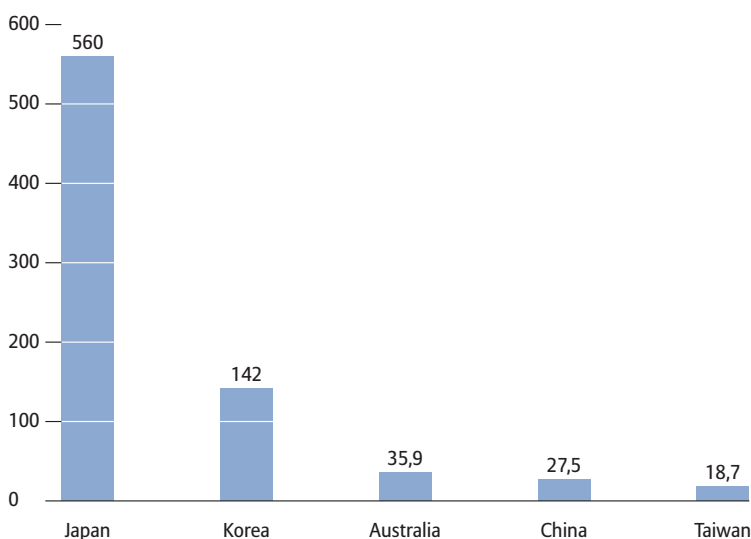
A way to do so and to circumvent the above-mentioned investment issues is to oblige the managing institution to adhere to the goal of return maximisation by outlawing other goals, or by outsourcing of assets or by introducing greater distance from government interference. These measures support a de-politicisation of investment policies, which eases equity investments and asset diversification. In addition, these measures imply increased professionalisation of asset management, which helps the goal of return maximisation to be realised. Asian pension funds have suffered from the constraints of

reserve fund investing because their assets are huge. (Chart 1)

With EUR 560 billion in assets, the Japanese Government Pension Investment Fund is by far the biggest reserve fund in Asia and the largest pension fund worldwide.² This capital originates from a long-standing surplus of contributions over pension benefits, which has persisted since its inception in the 1940s, but has been getting smaller (Sakamoto 2005). South Korea's National Pension Fund is the fourth largest pension fund globally and has assets of EUR 142 billion under management. The Korean pay-as-you-go system was established in 1988 and the minimum period of membership is 20 years, so capital accumulation could proceed rapidly over this period. Founded in 2006 and intended to fund public service pension liabilities, the Future Fund in Australia is the youngest reserve fund in the sample. Financed by budget surpluses and privatisation proceeds, it could accumulate EUR 35.9 billion within its first year of existence.

² Although the Social Security Trust Fund in the U.S. is larger in terms of asset volume, all of its investments are in non-tradable securities issued by the US Treasury, so that it normally is not considered.

Chart 1 Size of Asian reserve funds 2006* [EUR bn]



* Or latest year available

Source: OECD 2007b, national sources

China's National Social Security Fund was established in 2000 and is capitalised from several sources. Its assets amounted to EUR 27.5 billion in 2006.

These funds are still accumulating assets. It is estimated that the assets of Japan's Government Pension Investment Fund will peak in 2050; in South Korea, assets will probably accumulate until mid-2040. China's National Social Security Fund is unlikely to start decumulation before 2030, and Australia's Future Fund has been recently established.

The governance structures and the investment policies of Asia's pension reserve funds are in a process of substantial reform. Three key trends can be detected.

- **Reform of the board structures and increasing independence of reserve funds:** In three of the four countries (Australia, Japan, South Korea), the reserve funds are or will become an independent public agency. This will diminish government influence on the funds and, consequently, on investment policies. China is the exception. At the same time, increased board professionalisation is noticeable with financial experts exerting greater influence in the governance of the funds either through an advisory role to the boards, or through direct representation as board structures change from representative to professional boards staffed with financial experts.
- **Increased return orientation and a retreat from public project financing:** Given the importance of pension reserve funds for the operation of public pay-as-you-go systems in the future, reserve funds have adopted a heightened return orientation. The reserve funds in Japan and South Korea used to be considerably involved in

public and government projects, which returned low yields. This involvement was stopped and assets invested in the financial markets. The reserve funds of the other countries have not been investing in this type of projects.

- **Outsourcing to private asset managers and diversification of investments:** Congruent with increased return orientation, the outsourcing of assets to private asset management companies has increased substantially. The main motivation is to achieve higher returns through the professionalisation of investment management. This goes hand in hand with a diversification of assets. There is a move away from investing primarily in bonds and an increasing tendency to invest in the international markets, mostly through outsourced assets, and, in the case of South Korea, also in alternative asset classes.³

Among the four countries investigated, Australia and China run strategic reserve funds financed by fiscal transfers and dedicated to cushion the impact of ageing on the public pension system (although the Australian fund is confined to pension liabilities from the public service). In Japan and South Korea, the capital of reserve funds stems from a surplus of contributions over payouts. As the capital accumulated stems from public sources, contributions or general budget revenues, the government is necessarily involved in the governance of the funds. In all countries, the boards or the chair of the board, are appointed by the government. However, the degree of government influence differs between full government control of the fund in China and the establishment of the fund as an independent agency, as is the case in Australia, Japan and soon in South Korea. (Table 2)

³ These trends are in line with recent World Bank recommendations on the governance of public pension funds, namely clear objectives, institutional independence from government, long-term funding sources and a small board of experts among others (Vittas, Impavido, O'Connor 2008).

In terms of internal governance, the main difference is between a professional and a representative / government board. The former consists of members appointed because of their financial expertise, while the latter includes groups with a stake in the pension system, such as employers and employees. Obviously, the professional board is more conducive to a focus on returns in investment management, while the latter type also allows non-financial concerns to be considered. Reform plans in South Korea foresee

that a board of investment professionals will replace the representative board structure, consisting of government officials and stakeholders. Investment professionals also make up the management board of Australia's future fund. In Japan's reserve funds, experts have been given a much greater role than in the past though the establishment of an advisory body. China is an exception; here the board is made up of current or former government officials.

Table 2

	Australia	China	Japan	South Korea
Type of fund	Strategic reserve fund	Strategic reserve fund	Reserve fund	Reserve fund
Independence from government	Yes	No	Yes	Currently no, in the future yes
Type of board	Professional	Government-controlled	Professional	Representative (to be changed into professional board)
Appointing body	Treasury / Ministry of Finance and Administration	State Council	Ministry of Health, Welfare and Labour	Ministry of Health and Welfare
Outsourced assets [%]	TBD / Fund not fully operational	37	60	7
Foreign investments [%]	3.9	N.A.	26	8
Bond / deposit share [%]	74	63	63	87
Predefined target return	Yes	No overall target return	Yes	Yes

Source: OECD 2007b, national sources

Despite these differences in governance, the investment policies of all countries have changed substantially over the last years. Outsourcing and diversification of assets have grown considerably. Outsourced assets of China's NSSF increased from zero at the time of establishment in 2000 to 37% in 2006 (OECD 2007b). Australia's fund will outsource active management; what sorts of assets will be managed internally is not yet decided. In South Korea, outsourced assets have grown from 3.1% to 7.3% between 2003 and 2005 and outsourcing will accelerate in the years to come. In addition, in 2007, the Asian reserve funds granted several major outsourcing mandates. South Korea is also a good example for the increasing diversification of assets. Its National Pension Fund, which already invests in alternative assets, granted a major mandate for alternative investments last year, and will substantially increase the portion of domestic and international equities in the near future.

Closely related to investment policy is a predefined target return for the reserve fund. It helps to clearly define goals of reserve fund investment management and to measure them. In this sense, clear targets also support transparency of the investment process and a focus on performance. Australia, Japan and South Korea use this instrument. China has set target returns for fixed-income products and strategic investments, but no target return for the whole fund.

In all, these tendencies imply that investment management of the Asian reserve funds has become much more sophisticated and more return-oriented. The remainder of this paper provides a more detailed analysis of the design, the operation and the investment policies of the respective reserve funds.

Country Developments

Japan: the Government Pension Investment Fund

Of all the pension reserve funds considered in this paper, the Japanese Government Pension Investment Fund (GPIF) has the longest history. It is the largest pension fund in the world and, for reasons considered later, it will even increase its assets substantially over the next few years. The GPIF manages the reserves of the two pillars of public pensions in Japan, the flat rate National Pension and the earnings-related Employee Pension Insurance. The former was established in 1959, the latter in 1944. The reserves stem from surpluses of contributions over payments.

The GPIF itself is a relatively new institution. Until the 2001 reform, the reserves were entrusted to the Trust Fund Bureau of the Ministry of Finance. The pension reserves, together with the savings of Postal savings and Postal life insurance, were used to finance the Fiscal Investment and Loan Schemes, investing primarily in public infrastructure (Usuki 2002). A portion of the reserves was earmarked for loans for welfare facilities, such as hospitals. In the 1980s and 1990s, there were steps to invest the money more profitably by placing it with financial institutions. In all, the surpluses of the pension system were publicly managed with a focus on fostering public projects at the price of very low returns (Casey 2004).

This has changed with a substantial reform in 2001, which was helped by the growing awareness of the magnitude of the demographic change Japan faces and the resulting centrality of pension reserves.⁴ Responsibility over the reserve fund was transferred to the Ministry of Health, Labour and Welfare and investment decisions should not be taken in the “public” interest any longer, but in the interest of the beneficiaries, implying a higher

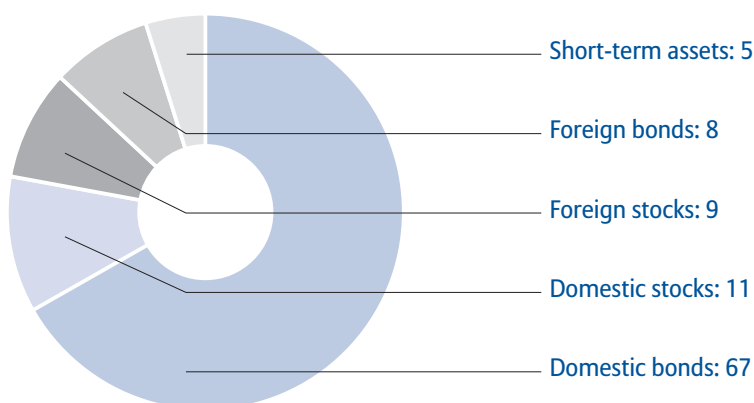
return orientation. The GPIF was founded to manage the reserves. Simultaneously, disclosure and audit were strengthened. In 2006, the GPIF gained independence from the government when it became an independent administrative organisation.

The board consists of two members, the president and the executive managing director. The Minister of Health, Welfare and Labour appoints the president, who then in turn appoints the executive director. The Minister also sets the mid-term objectives although he is not involved in operational matters, as used to be the case (Global Pensions 2006). The Investment Committee within the GPIF provides expert advice. The Minister for Health, Labour and Welfare appoints its members, who must have expertise in finance and economics or other academic qualifications. The committee supervises GPIF investments and gives recommendations to the president of the GPIF.

Investment policy takes place within predetermined limits. The asset allocation to be reached by the end of fiscal 2008, when the transfer of all assets will be completed, is preset. This principle portfolio aims to meet the targeted rate of return, which is 3.37%. (Chart 2) There is a permissible range of deviation of 5-8% for each asset class. At the end of fiscal 2006, domestic bonds accounted for 52% of the portfolio, domestic stocks for 22%, foreign bonds for 11% and foreign stocks for 15% of the assets.

There are guidelines regulating the scope of internal asset management. The GPIF is only allowed to manage bonds in-house (Sakamoto 2005). In reality, only passively managed domestic bonds are administered

4 Japan has one of the fastest ageing populations in the world. In fact, many observers consider the country to be the oldest society in the world even now. The current old-age dependency ratio stands at 30 and is projected to worsen to 74 in 2050. During the same period, Japan's population will decrease from 128 million to 102 million (Allianz Global Investors 2007).

Chart 2 Target portfolio of the Government Pension Investment Fund 2008 [%]

Source: OECD 2007b

internally. All other assets are outsourced (Global Pensions 2006). Generally, the GPIF relies on passive management for most of its assets. Only a fifth of assets are managed actively, because active management can only be used when the GPIF has a strong belief in outperformance. Besides, the sheer size of the GPIF complicates active management (Global Pensions 2007). Foreign investments in the portfolio account for 25.5% of assets.

In 2005, the GPIF had assets of around EUR 560 billion (JPY 88 trillion) under management. The magnitude of outsourced assets is estimated to have been EUR 337 billion (JPY

53 trillion) (Nomura Research Institute 2006). However, not all assets have yet been transferred to the GPIF; the transfer is supposed to be completed in 2008. Then, according to estimates, the GPIF will have assets of around EUR 1.1 trillion (JPY 166.5 trillion) and outsourced assets of EUR 719 billion (JPY 113 trillion) (Nomura Research Institute 2006).

In all, the management of Japanese pension reserves has undergone a shift towards professionalisation of asset management. This is marked by a bold move away from investing primarily in government or welfare projects and by turning the GPIF into an independent agency.

South Korea: the National Pension Fund

South Korea established a partially funded pay-as-you-go system in 1988. As the minimum membership period for benefits is 20 years, benefit payments will only start in 2008. Consequently, the National Pension System has accumulated a substantial amount of assets. The National Pension Fund is the largest institutional investor in

South Korea and fourth largest pension funds in the world with assets under management of EUR 142 billion (KRW 172 trillion) in 2006. According to official statements, its size could increase ten-fold until 2025. However, due to the rapid ageing of South Korea's population, the fund will be depleted by 2062, according to IMF projections (IMF 2007).⁵

5 South Korea faces one of the most severe demographic challenges in the world. Today's dependency ratio stands at 13. It is expected to rise to 64 by 2050. The dependency ratio in South Korea is changing faster than in any other OECD country. While the proportion of elderly people is currently the second lowest in the OECD, it will be among the highest by 2050.

The governance structure of the National Pension Fund is in transition. Currently, the fund is managed by the government, or more specifically the Minister of Health and Welfare. The highest decision-making body within the National Pension Fund is the National Pension Fund Management Committee. It is a representative board and decides on issues like fund management guidelines and plans. The committee consists of twenty-one members; the chair is the Minister of Health and Welfare. The other members are deputy ministers from related ministries (5), the chair of the national pension service, representatives of business and employer organisations (3), representatives of labour organisations (3), representatives of several other organisations, such as agriculture or consumer protection (6) and financial experts (2). The committee's plans have to be coordinated with the Ministry of Planning and Budget and the Ministry of Health and Welfare, before they are submitted to the Cabinet Council and the National Assembly, which has to agree.

In the second half of 2007, the government announced plans to fundamentally restructure the NPF's governance system. The plans foresee that seven professionals from the private sector will replace the current 21 members of the management committee. Also discussed is the recruitment of non-Korean financial experts for the committee. The chair would be appointed by the Korean president on recommendation of the prime minister. Equally important, the National Pension Fund should be run as an independent public enterprise, separated from other pension organisations, in which it is currently included. The fund might also be divided up (Korea Times 15. November 2007 and 11. September 2007).

The second governance layer is currently the National Pension Fund Evaluation Com-

mittee. It advises and assists the management committee regarding the management of the fund in areas such as performance measurement, composition of fund assets and monitoring. Its composition is similar to that of the management committee with 21 members, the Vice Minister of Health and Welfare as Chairman, seven officials and representatives of societal groups. Finally, there is the Fund Management Centre for internal asset management and the National Pension Research Institute, which has several research tasks regarding the pension system and the management of the fund.

Over the last years, the investment policy of the National Pension Fund has seen substantial changes. The fund traditionally invested in three sectors: the public, welfare and financial sectors. Public sector investments refer to public projects, such as regional development or infrastructure. Welfare sector refers to the funding of loans and welfare facilities. Examples include loans for tuition or medical expenses, while welfare facilities include old-age care centres or hospitals. Allocation in these two sectors used to demand a significant share of the National Pension Fund's assets with a strong preponderance of investments in the public sector.

It is obvious from table 3 that investments in the public and welfare sectors were almost completely abandoned in favour of financial market investments. Part of the explanation is that until 2004 government bonds were classified as public sector investment, after that time they have been counted as investments in the financial sector. Despite that, the main reason for the decrease to nil is that, since the early 1990s, several funds had to deposit capital in the Public Fund to be used for public projects. This obligation was rescinded in 2000, mainly due to poor returns,

Table 3 Asset allocation of NPF funds

	Public	Welfare	Financial
1990	46.3	0	53.7
1995	65.4	4.0	30.6
2000	56.9	1.2	41.9
2005	0.0	0.2	99.8

Source: National Pension Research Institute 2007

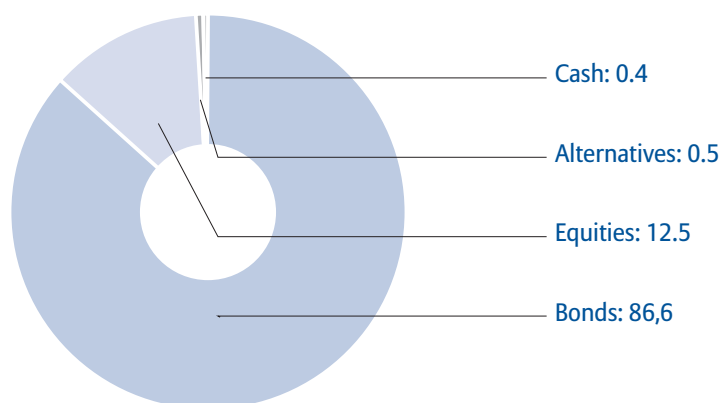
and the deposited funds given back by 2005. The returns on these investments were considerable lower than those for financial market investments. For example, in the period 1995 to 2005, the returns on financial market investments were 2.3 percentage points higher than the public sector investments and 3.4 percentage points higher than the welfare sector investments (National Pension Research Institute 2005).

The main principles of the NPF investment policy are the long-term stability of the fund, maximising returns at a given risk level, and a contribution to the national

economy and the development of financial markets. The long-term target investment return is higher than the expected GDP growth rate (National Pension Research Institute 2005). The NPF invests in domestic and foreign bonds, domestic and foreign stocks and, in a recent development, in alternatives like private equity. Each asset class is expected to perform at least as good as the benchmark. Looking more closely at the current asset allocation, it shows that most assets are invested in bonds. (Chart 3)

Blue chip equity investments are usually passively and internally managed, while

Chart 3 Asset allocation of NPS investment in the financial sector 2005 [%]



Source: National Pension Research Institute 2007

outsourced mandates are actively managed. Bonds are normally managed in-house, but can be outsourced according to limits stated in the annual fund management plan. Alternatives are managed externally, except for infrastructure investments and loans (National Pension Research Institute 2005).

There has been a tendency to increase outsourcing of assets over the last years, although at a low level. For example, in 2005, 7.3% of assets were outsourced, in 2003 it was 3.1%. Within the bond category, there is a shift toward foreign bonds, which increased from 0.6 to 7.3% of assets. Since then, outsourcing has continued. In 2007, the NPF awarded two mandates of USD 950 million (EUR 687 million) combined to foreign external managers. These mandates are for overseas investments.

As with the governance structure, the investment policy of the NPF is also about to change fundamentally. The fund plans to increase its equity investments to 30% by

2012, while overseas equity investments are set to rise to 10% from 0.4% in 2005. At the same time, bond investments are intended to decrease to 50% (Korea Times 15. November 2007). The motivation for this change in policy is the same as for the governance reforms, namely to boost investment returns.

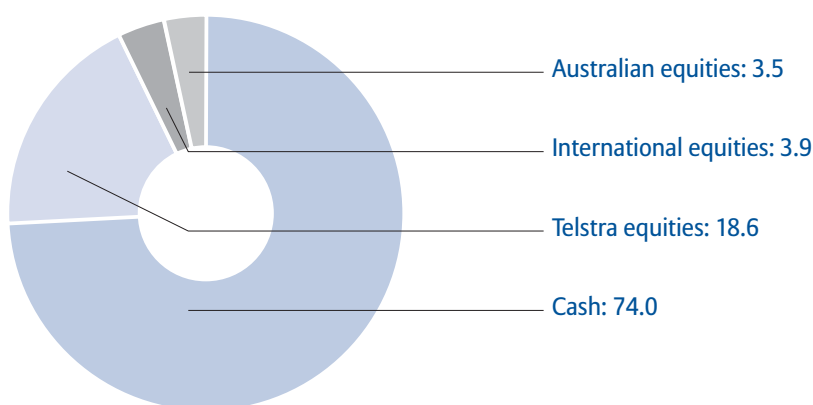
In all, the NPF is currently a government controlled institution, which over the last years has withdrawn from financing government or welfare projects and shifted its investments almost completely towards the financial market. Simultaneously, there is an increasing trend towards outsourcing to asset managers as a consequence of a more pronounced return orientation. This higher return orientation also induced planned reforms in governance and investment policy. Governance is set to be more professionalised, while the investment policy will be more geared to equity and international investments. In this sense, South Korea is a pronounced example of the trends underway in Asian reserve funds.

Australia: the Future Fund

The Australian pension reserve fund was only established in 2006. The Future Fund aims at funding costs arising from unfunded public sector superannuation liabilities. These liabilities will become payable to public servants and defence personnel from 2020 onward. Current unfunded liabilities, which amount to EUR 2.7 billion (AUD 4.5 billion) per annum, are covered by the government budget. Liabilities are expected to grow to around EUR 88.5 billion (AUD 148 billion) by 2020 and to more than EUR 119.6 billion (AUD 200 billion) by 2046. The Future Fund is funded by budget surpluses and privatisation revenues. Its balance in 2007 was approximately EUR 35.9 billion (AUD 60 billion). It

is expected to hit its planned asset target of EUR 88.5 billion (AUD 148 billion) in 2020.

The Future Fund Board of Guardians, an independent body, supervises the fund. The board is responsible for strategic investment decisions and is accountable to the government for asset performance. The government appoints the members of the board for a period of up to five years, the main selection criteria being expertise in asset management. Indeed, all members of the board do not have a background in government services, but in private, financial market-related companies. Administrative and operational functions

Chart 4 Asset allocation Future Fund 2007 [%]

Source: Future Fund

are carried out by the Future Fund Management Agency, which supports the board and recommends on investment strategies.

The targeted long-term return of the Future Fund is determined in the investment mandate issued by the Treasury and the Minister for Finance and Administration. Currently, the target return is 4.5-5.5% per annum above the Consumer Price Index over the long-term, while during the transition period on the way to a long-term asset allocation, a lower return is expected.

In 2007, the Australian government transferred its remaining stake in the telecommu-

nications and media company Telstra to the fund, valued at EUR 5.3 billion (AUD \$8.9 billion). The fund is not yet fully operational, so there is a strong overweight in cash. (Chart 4) As soon as the long-term investment plan is set-up, asset allocation will change substantially. The goal is to have a widely diversified portfolio in the long run, the foundations of which will be built up over the next years. According to announcements, active management will be outsourced, although the split between active and passive management as well as the degree of outsourcing is not clear yet.

China: the National Social Security Fund

The Chinese National Social Security Fund (NSSF), a strategic pension reserve fund, is fed by fiscal transfers in order to build up capital for coming public pension deficits resulting from upcoming demographic development.⁶ In its baseline scenario, the World Bank estimates that China's implicit pension debt stands at 141% of its 2001 GDP (Sin 2005).⁷ The

NSSF was founded in 2000, and is in the accumulation phase. It is unclear when payments will start. Some sources think that decumulation will begin when the fund reaches assets of at least EUR 97.2 billion (RMB 1 trillion). Others suggest that decumulation will commence from 2030 onwards, when the demographic situation is projected to deteriorate.

6 Between 2005 and 2050, the old-age dependency ratio in China is expected to worsen from 11 to 39; the median age will rise from 32.5 to 48 years in the same period. While the absolute numbers appear relatively favourable compared to industrialised countries, the speed of ageing in China is exceptional. Essentially, China will age significantly within one generation.

7 Implicit pension debt is the present value of unfunded pension liabilities or promises.

Assets of the NSSF come from four sources:

- Fiscal transfers from the central government budget
- Proceeds from the listing of state-owned enterprises
- Lottery proceeds
- Investment income

The bulk of NSSF assets comes from fiscal transfers, followed by the proceeds of privatisation, investment income and lottery income. The proceeds from privatisation come from the Initial Public Offerings (IPO) of state-owned enterprises, which must grant 10% of money raised from an IPO to the NSSF, as well as from overseas listings. In 2006, the NSSF's total assets amounted to EUR 27.5 billion (RMB 283 billion).

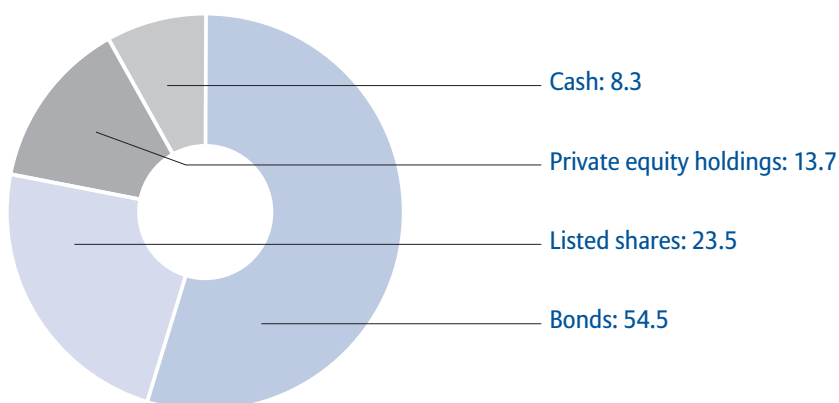
The NSSF is managed by the National Council of the Social Security Fund (NCSSF), which was established simultaneously to the fund. It is an organisation with the status of a ministry and directly reports to the State Council, the government's cabinet. The NCSSF comprises 17 executive board members and is led by a chair and three vice chairs, which are nominated by the State Council. The re-

maining directors are also appointed by the State Council. Many NCSSF officials have a background in other key government departments (Leckie, Pan 2007). This means the NCSSF is not independent, but fully integrated in the state administration. Tendencies to grant pension reserve funds a higher independence from government, as in other countries, are not discernible in China. However, the independence of reserve funds tends to occur in countries with a higher economic development.

The NCSSF is responsible for managing NSSF assets, developing its investment policy, selecting external fund managers, and for finance and controlling. The NSSF investment policy is based on the priorities of asset security and liquidity. As a result, regulations specify that deposits and government bonds combined must amount to at least 50% of assets. At least 10% must be invested in deposits alone. The maximum limit for corporate bonds is 10%, and the combined limit for shares and mutual funds is 40%.

The asset allocation of the NSSF was conservative in the initial period of operation.

Chart 5 NSSF asset allocation 2006 [%]



Source: Leckie, Pan 2007

In 2000, all assets were invested in bank deposits and government bonds. However, this picture has begun to change. In 2006, the share of equities has increased significantly to 23.5% of assets managed. (Chart 5) A notable share of assets is devoted to direct equity holdings, mainly pre-IPO investments in Chinese enterprises, especially in banks. NSSF management plans foresee that direct equity investments should generate a return of at least 6%, while fixed-income products should generate at least 3.5% (Sekine 2007).

Besides investments in higher-risk assets, outsourcing is a second major trend in the NSSF investment policy. The share of outsourced assets has increased steadily, from 24.1% in 2003 to 37.3% in 2006. In 2003, the NSSF began outsourcing its assets to domestic asset managers, which were allowed to invest up to 40% of these assets in stocks. In 2005, five national and/or joint ventures were selected to manage NSSF assets. In 2006, new regulations were issued that

allowed the NSSF to invest internationally those assets raised through IPO proceeds abroad. Following this, the NSSF allotted five investment mandates to ten foreign asset managers and one joint venture to manage international investments of EUR 758 million. The mandates foresee investments in Hong Kong stocks, global stocks, US stocks, global bonds and foreign currency.

The shift in investment policy towards higher risk assets and outsourcing seems to have paid off for the NSSF. The realised rate of return has jumped from 2.75% in 2002 to 9.34% in 2006 (Sekine 2007), helped by the performance of the Chinese stock markets. Generally, the NSSF fills an important gap in the pension system. While the country is only in the process of setting up a comprehensive pension system, from a public finance point of view, it is a good idea to provide for the foreseeable liabilities of this new system to make it sustainable in the long run.

Conclusions

The governance and investment policies of Asian pension reserve funds are in transition. Their strategic reorientation can be described succinctly as putting returns first. This strategy is supported by increased outsourcing of assets and their diversification, the retreat from financing functions for government and public projects and the professionalisation of board governance. These developments benefit future pensioners, whose pension payouts are partly dependent on the performance of the assets managed by the reserve funds. In this way, professional management of the huge pension reserves is critical for the sustainability of public pensions. As pension reserve funds are necessarily investors with a very long-term horizon, sophisticated risk manage-

ment is decisive for long-term stability of pension reserves.

The patterns observed also have wider ramifications for financial markets. The rising share of international and equity investments in the portfolios of Asian reserve funds imply that the importance of these funds as an actor on the global financial markets will increase substantially. As in the case of sovereign-wealth funds, their sheer size and societal impact will bring issues like internal governance, investment processes, political influence and transparency inevitably into the public spotlight. This will make clear goals, sophisticated investment strategies and solid governance structures all the more important.

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