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AIJ scandal: superficial and deeper issues facing Japanese pension funds

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Japanese pension funds suffered huge losses from fraud alleged to have been perpetrated by AIJ Investment Advisors. To avoid such fraud, pension funds need to possess sufficient asset management expertise on staff. Also needed are legal reforms to permit pension funds to appoint outside experts to their governing boards and enlarge their scale through pooled management of assets.

On the surface, the recent AIJ Investment Advisors scandal is the case of fraud. Averting similar problems in the future therefore requires safeguards against fraud. In addition to the superficial issue of avoiding fraud, efforts must be made to address the root issue of strengthening pension fund management. Below, I first discuss how to avoid fraud such as the AIJ case and then propose ways to strengthen pension management. In doing so, I focus mainly on improvements with respect to asset management instead of delving into systemic issues such as the existing pension fund system's deficiencies.

Checkpoints for avoiding fraud

When investing in foreign-domiciled funds, including hedge funds, pension funds should check two key points. Specifically, they need to understand the fund's investment strategy and its structure. In terms of the former, the most important point is ascertaining the sources of the fund's returns. Fund investing requires an understanding of the sources of both returns derived directly from the assets in which the fund invests (beta) and excess returns attributable to the asset manager's skill level (alpha). Pension funds need to be able to identify the types of market environments in which a prospective investee fund most often delivers positive beta and understand the principles underlying its alpha generation.

Once a fund's sources of returns are understood, the second step is to ascertain whether the fund operates under a sound organizational structure[1]. If the prospective investee fund is legally organized as a company, a pension fund should check several points. The first is the composition of the fund's board of directors. Specifically, does the board include qualified third-party directors unaffiliated with the fund's management company? Second, is risk management conducted by an organizational unit independent of the portfolio management team? Third, has the fund hired a specialized third-party institution unaffiliated with its management company to serve as fund administrator?

In previous cases of fraud, investors often seem to have failed to adequately check these points. In the AIJ case, few if any of the defrauded pension funds appear to have understood the investee funds' investment strategies, which is the first checkpoint. As a pension consultant, I queried AIJ about its investment strategy in 2007 on behalf of a certain pension fund. At the time, all AIJ would tell me was that its funds earned returns from option strategies[2]. I was unable to determine how the funds were generating alpha. If the defrauded pension funds had practiced good fiduciary sense by not investing in anything they did not understand, the first checkpoint most likely would have deterred them from investing with AIJ.

In terms of the second checkpoint, detailed analysis of the AIJ funds reveals that most functions were conducted in-house with no third-party oversight and that fund managers had free reign to discretionarily invest portions of pension fund assets without the clients' permission[3]. It is unclear, however, whether these facts were clearly disclosed in the original documentation provided to clients. Additionally, if everyone affiliated with AIJ was intentionally acting in bad faith to deceive clients, there is not much a pension fund could have done to detect the deception.

Deeper issues facing pension funds

Though it may not be possible to avoid falling victim to fraud 100% of the time, performing due diligence on prospective investee funds is essential. This process requires a certain degree of expertise. Ascertaining the source of a fund's returns does not require asset management experience but it does require sufficient knowledge of finance.

How do pension funds gain such expertise? The key issues are where personnel with such expertise should be posted within a pension fund's organization and how to establish conditions conducive to recruiting such personnel. I will address these issues in the context of pension schemes that require a pension fund to be established as an independent entity to manage the pension plan's assets[4].

Broadly speaking, pension fund organizations typically comprise a governing board[5] and pension fund staff that run the fund on a day-to-day basis. Ideally, both the board and staff should include personnel with the aforementioned skills and possess sufficient supervisory and executive expertise.

First, governing boards are legally required to be composed of representatives of a pension plan's sponsor, participants and beneficiaries. Pension funds are thus precluded from appointing outside experts to their governing boards. However, few nonfinancial companies have internal asset management departments. It is generally not feasible for companies to internally recruit staff with the aforementioned skills and appoint them to the board. Existing laws must be amended to permit pension funds to appoint outsiders with specialized expertise to their governing boards. Another possible approach is to retain the services of a pension consultant or other advisor, but it is more prudent to take the view that a pension fund cannot be properly managed unless such expertise resides on its governing board, which is vested with the heavy responsibility and authority to manage the pension fund.

Pension fund staff, on the other hand, are responsible for actual day-to-day management of pension assets. To ensure an effective oversight function, a pension fund must employ at least several personnel with the requisite level of expertise. However, hiring qualified personnel is quite costly. In this respect, a fund's size is a major constraint. A pension fund with assets of less than ¥100 billion is too small to realistically afford to hire staff with such expertise. Funds without this minimum level of assets have little prospect of being able to recruit staff with sufficient skills to adequately fulfill pension management duties. Currently, only 7% of all corporate pension funds have assets of ¥100 billion or more[6]. To enlarge their scale, pension funds would likely have to merge to form larger funds that manage multiple sponsors' pension assets.

However, appointing outsiders to pension funds' governing boards and pooling pension fund assets are easier said than done. If pension funds cannot hire staff or appoint directors with the requisite expertise, they should consider completely outsourcing management of pension assets. In the Netherlands, some pension funds without adequate in-house human resources outsource their management to specialized institutions[7] that select fund managers and dynamically adjust asset allocations subject to risk constraints set by the fund's governing board. Such an approach is worth considering in Japan also.

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Note

1) This step is known as checking a fund's governance structure.

2) Incidentally, I did not receive any explanation of fund structure either.

3) Hedge funds call such arrangements a "side pocket."

4) In Japan, Employees' Pension Funds (EPF) and fund-type Defined Benefit Corporate Pension plans meet this criterion. Contractual Defined Benefit Corporate Pension plans are excluded from this analysis because they can be managed internally by the sponsor company.

5) In the case of EPFs and fund-type DB Corporate Pension plans, the board is usually called a Board of Representatives. Typically, the plan sponsor appoints half of the representatives on the board, and plan participants and beneficiaries elect the other half. The board usually has decision-making authority (e.g., to make asset allocation decisions) in addition to responsibility for supervision of pension fund staff.

6) Of 1,142 EPFs and DB Corporate Pension funds that responded to a Pension Fund Association survey, only 81 had assets of ¥100 billion or more (as of March 31, 2011).

7) In Europe such institutions are called fiduciary managers.

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