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How will expert panel's recommendations change public pension fund management?

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Executive Summary

An expert panel on public pension fund management has recommended a program of specific public pension fund reforms. The extent to which these reforms are carried out in accord with the recommendations will be a test of the government's executive capabilities.

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NOTE

1) The author was one of the panel's seven members. Other members included University of Tokyo professor Takatoshi Ito, who chaired the panel.

2) The pension funds within the purview of the panel's remit are public pension funds (GPIF, Federation of National Public Service Personnel Mutual Aid Associations, Pension Fund Association for Local Government Officials, and Promotion and Mutual Aid Corporation for Private Schools of Japan) and quasi-public funds organized as independent administrative entities (e.g., independent administrative entities other than GPIF, national university corporations).

3) Approved by the Cabinet on June 14, 2013.

An expert panel[1] on public pension fund management submitted its final report to Economic Revitalization Minister Akira Amari on November 20, 2013. The panel was established to recommend cross-disciplinary reforms for public and quasi-public pension funds[2] with respect to portfolio management (e.g., further diversification of asset holdings), governance (including risk management) and measures to improve returns on long-term equity investments based on the Japan Revitalization Strategy[3] formulated as a national growth strategy, Abenomics' so-called third arrow.

The panel's recommendations have attracted considerable attention both in Japan and abroad, given that Japanese public and quasi-public pension funds have aggregate assets of over ¥200 trillion and the recommendations are likely to have a major impact on their future investment policies. Following are my personal views on the recommendations' significance and how Japanese pension fund management will (hopefully) change in response to the recommendations.

Importance of boosting returns within predetermined risk parameters

Because the panel was convened as part of the government's growth strategy, many seem to be under the misimpression that its purpose was to advise public pension funds to adopt more aggressive, riskier portfolio configurations than their current asset allocations. On the contrary, the panel's position was that public and quasi-public pension funds each have different investment objectives and should invest in accord with risk policies consistent with their respective objectives. The key issue addressed by the panel was whether current investment practices are optimal to achieve agreed-upon investment objectives within the current investment environment.

The panel recommended a number of reforms for pension funds to better achieve their investment objectives. Its most important recommendation is to further diversify investment holdings[4]. As long-term investors, pension funds should be able to boost their returns fairly reliably by assuming risks to which short-term investors are averse, most notably liquidity risk. If pension funds effectively diversify further, they should be able to capture higher returns without assuming much more risk than they already are.

The panel wants public pension funds to revise their investment strategies, even for their existing listed equity holdings. One specific recommendation is to switch to different benchmarks for Japanese equities. The panel felt that public pension funds have a duty to prod corporate management to focus more on capital efficiency in managing listed companies. Long-term equity returns vary as a function of investee companies' capital efficiency. Improvement in capital efficiency will therefore boost equity investment returns and should consequently help stabilize pension benefits. If pension funds continue using equity benchmarks like the TOPIX (Tokyo Stock Price Index) that include companies with low capital efficiency, they are unlikely to be able to induce corporate management to embrace management discipline, including improved capital efficiency. Whether new benchmark equity indices[5] have higher returns than existing benchmark indices is largely immaterial from a long-term standpoint (although it is important from a short-term standpoint).

Another of the panel's recommendations is that upgrading public pension funds management will require improved risk management and fund governance for decision-making. For example, investing in illiquid assets requires a different skill set than the status quo, particularly risk-management capabilities including asset selection and valuation. Public pension funds' costs, including employee compensation, would also most likely rise. Initiatives to increase investment returns must be accompanied by clear external accountability. In this regard, establishing governing boards or other such bodies with the requisite expertise will be crucial.

GPIF reform will transform Japanese pension fund investing as a whole

Of the many public and quasi-public pension funds within the panel's remit, the largest by far is the Government Pension Investment Fund (GPIF). With assets of over ¥120 trillion, the GPIF has a big influence on other funds. Accordingly, the panel's recommendations included a separate program of portfolio management and governance reforms specifically for the GPIF (see table).

The proposed GPIF reforms are split into three timeframes[6] and include specific recommendations concerning portfolio composition, risk management and

4) Examples of potential portfolio diversifiers mentioned in the panel's report include REITs, real estate, infrastructure, venture capital, private equity and commodities.

5) The panel report mentioned the JPX-Nikkei 400 as a potential new benchmark index. However, several leading pension funds have questioned the feasibility of immediately using the JPX-Nikkei 400 as a benchmark. In their opinion, it would be too risky to adopt the JPX-Nikkei 400 as a benchmark before JPX-Nikkei 400 futures are available to trade.

6) The timeframes are immediate-term (within a few months), intermediate-term (within one year), and longer-term (within about two years, contingent on passage of legislative amendments).

Proposed GPIF reform program

	Immediate actions	One-year timeframe actions	Longer-term aims
Portfolio management reforms (further diversification, etc.)	•Revise portfolio management within existing policy asset mix (e.g., flexibly manage portfolios using permissible range of deviation from policy asset allocations, revise active management) •Review return targets and risk tolerances •Consider adopting new benchmarks for passively managed assets	•Adopt new policy asset mix based on results of actuarial review •Expand universe of investable assets (mainly highly liquid and easily valued assets) •Set up baby funds	•Expand universe of investable assets (including illiquid assets and assets for which market values are not consistently available)
	Portfolio management reforms and governance, including risk-management, reforms must be implemented as a coordinated package		
Risk management reforms	•Formulate and implement risk management measures in anticipation of inflation and rising interest rates (e.g., investment in inflation-indexed government bonds, utilization of derivatives as risk hedges) •Consider forward-looking risk analysis	•Reconfigure portfolio based on forward-looking risk analysis in light of results of actuarial review	•Implement risk management measures in conjunction with expansion of universe of investable assets (including illiquid assets and assets for which market values are not consistently available)
Governance reforms	•Introduce medium/long-term performance-based compensation for external asset managers •Begin preparing to recruit personnel with highly specialized expertise	•Ease restrictions on employee headcounts, salary levels and overhead expenses, convert Investment Committee members to full-time employees and hire personnel with highly specialized expertise	•Establish governing boards by reorganizing funds as a different form of legal entity and assemble portfolio management staffs with highly specialized expertise

Source: Expert panel's final report (November 20, 2013)

governance reforms. Implementation of these recommended reforms will require existing cost restrictions to be relaxed. The GPIF and other public pension funds are independent administrative entities, and as such, they are subject to strict spending restrictions. The objective of managing public and quasi-public funds is not minimizing costs, but maximizing after-cost returns in accord with predetermined risk policies. To increase returns, public pension funds must incur additional costs to some extent. To do so, they would need Cabinet approval[7] to ease existing operating expense restrictions at an early stage of the reform process.

7) Independent administrative entities are subject to uniform cost restrictions. Lifting these restrictions would require Cabinet approval.

Another important point in terms of further diversifying investment holdings as recommended by the panel is clearly defining investment risk. For example, public pension funds differ in their approach to risk-taking[8] despite all having a statutory mandate to "safely and efficiently manage pension reserves from a long-term standpoint solely for the benefit of pension beneficiaries." One idea is to fulfill both the safety and efficiency mandates by dividing portfolios into two buckets. For example, pension funds can interpret safety to mean reliably paying prescribed benefits and set up subfunds predominantly invested in bonds to generate sufficient cash flow to meet benefit obligations. If pension funds construe efficiency to mean maximizing long-term returns at a given risk level, they could diversify their asset holdings much more than they do now. By doing so, they should gain various opportunities to capture returns.

8) The panel found that public pension funds utilize different approaches to portfolio construction. For example, the GPIF seeks to maximize returns at a risk level equivalent to that of domestic bonds, whereas Mutual Aid Associations first set return targets and then select the least risky portfolio with an expected return sufficient to meet the target.

The extent to which the panel's recommendations are implemented will be a key focal point going forward[9]. Government ministries and agencies that oversee public pension funds may issue directives to the pension funds based on the panel's recommendations, but how truly such directives conform to the panel's recommendations remains to be seen. Realization of the recommendations will be a test of the government's executive capabilities.

9) The Japanese government's "Economic Stimulus for Realization of a Virtuous Cycle," approved by the Cabinet on December 5, 2013, instructed ministries and agencies that oversee public pension funds to draft specific recommendations. It stated that the Ministry of Health, Labor and Welfare and other concerned ministries and agencies will, based on the panel's recommendations, take action as needed to swiftly and steadily implement necessary reforms tailored to individual pension funds' size and other attributes while endeavoring to maintain the funds' long-term health.

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