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Countries

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ABSTRACT/RÉSUMÉ

Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries.

Many countries around the world are partly prefunding their otherwise pay-as-you-go (PAYG) financed social security systems by establishing or further developing existing public pension reserve funds (PPRFs). Most OECD countries have put in place internal and external governance mechanisms and investment controls to ensure the sound management of these funds and better isolate them from undue political influence. These structures and mechanisms are in line with OECD standards of good pension fund governance and investment management. In particular, the requirements of accountability, suitability and transparency are broadly met by these reserve funds. However, some specific details of the funds' governance and investment management could be improved in a few countries, such as enhancing the expertise in the funds' governing boards and constraining discretionary interventions by government. Such reforms will ultimately raise the long-term investment performance of the funds and the solvency of social security systems.

JEL codes: G18, G23, G28

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

La gouvernance et les investissements des caisses de réserve des régimes publics de retraite dans quelques pays de l'OCDE

De nombreux pays dans le monde procèdent à une capitalisation préalable partielle de leurs régimes de protection sociale qui reposent par ailleurs sur la répartition. À cet effet, ils dotent leurs régimes publics de retraite de caisses de réserve ou développent les caisses existantes. La plupart des pays de l'OCDE ont mis en place des mécanismes internes et externes de gouvernance et de contrôle des investissements pour veiller à la saine gestion de ces caisses et à mieux les isoler d'influences politiques indues. Ces structures et mécanismes sont conformes aux normes de bonne gouvernance des fonds de pension et de gestion des investissements. En particulier, ces caisses respectent de façon générale les impératifs de responsabilité, de qualification et de transparence. Cela étant, dans quelques pays, on pourrait améliorer des spécificités de la gouvernance et de la gestion des investissements, notamment en renforçant les instances dirigeantes de ces caisses et en limitant les interventions discrétionnaires des pouvoirs publics. Ces réformes permettront en dernière analyse d'améliorer les performances de long terme des investissements de ces caisses et la solvabilité des régimes de protection sociale.

Codes JEL: G18, G23, G28

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

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GOVERNANCE AND INVESTMENT OF PUBLIC PENSION RESERVE FUNDS IN SELECTED OECD COUNTRIES

by Juan Yermo¹

I. Introduction

Many countries around the world are partly prefunding their otherwise pay-as-you-go (PAYG) financed social security systems by establishing or further developing existing public pension reserve funds. This trend is parallel to the growing shift towards fully-funded, privately managed pension systems, which has in turn heightened the role of pension funds in retirement income arrangements.

The main defining feature of public pension reserve funds, which differentiates them from pension funds, is that their ultimate beneficiaries (the general population) do not have legal or beneficial ownership over the reserve funds' assets. Rather, the legal or beneficial owner is the institution that administers the public pension system (social security reserve funds - SSRFs) or the government (sovereign pension reserve funds - SPRFs). This feature of reserve funds exposes them to potentially greater state influence than pension funds and has been in the past one of the main reasons for favouring pension funds as a way to prefund pension benefits.

However, as shown in this paper, internal and external governance mechanisms and investment controls can be put in place in order to isolate reserve funds effectively from undue political influence. At a minimum, public pension reserve funds should be subject to similar governance and investment management standards as pension funds, following the "OECD Guidelines on Pension Fund Governance" first developed by the Working Party on Private Pensions in 2001 and revised in 2004 (OECD (2005a)) and the "OECD Guidelines on Pension Fund Asset Management" (OECD (2006a)).²

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.

The OECD and ISSA guidelines effectively address basic governance and investment management issues. However, in the case of reserve funds additional safeguards are needed to promote better protection from political manipulation of the funds. In particular, special care needs to be taken with the selection and

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² The report does not address the question of the role of these reserve funds in the corporate governance of the companies that they invest in. The relevant OECD standard on this issue is the "OECD Principles on Corporate Governance" (OECD (2004)).

appointment of the board of reserve funds, given their central responsibility in designing investment strategies.³

The report focuses on reserve funds in the following countries: Canada, France, Ireland, Japan, Korea, New Zealand, Norway and Sweden. In general, these reserve funds show good levels of governance, but some weaknesses have been identified that call for reforms. In particular, two of these countries, Korea and Japan, are implementing reforms to their funds' governance that should bring them further in line with international good practices. The report also addresses some aspects of investment management, comparing the practices in these countries against the OECD and ISSA guidelines. The main concern is the presence of some potentially restrictive investment rules in Sweden and political influence on the investment policy in countries such as Korea, Japan and Norway, as decisions over the funds' investment strategy are ultimately taken by a government ministry or parliament.

The policy implications of this report are particularly relevant to many non-OECD countries that have already or are in the process of establishing public pension reserve funds. Anecdotal evidence suggests that the internal governance features of some of these funds are weak and potentially exposed to undue political influence (see Impavido (2002)).

The report is structured as follows. The next section discusses the rationale for prefunding public pension systems via the establishment of reserve funds. Section 3 presents the recent evolution of reserve funds and the outlook for the future. Section 4 and 5 discuss respectively the main aspects of the governance and investment of these funds, using the OECD and ISSA Guidelines as reference of good practices. The last section concludes.

II. Why and how are countries prefunding social security?

Prefunding social security benefits can help governments respond more effectively to the fiscal pressures that will result from ageing populations. While prefunding may not in itself offset the decline in domestic growth rates that will result from worsening dependency ratios⁴ it can help to solvent some aspects of the demographic shock. The main reasons for prefunding via the establishment of reserve funds are:

- Tax-smoothing, that is, maintaining relatively constant contribution rates to the social security system. While such objective could also be met by appropriate management of the public debt, assets in the reserve fund are assigned to financing the social security system. Savings in the form of public debt reductions, on the other hand, may end up being used for other future outlays of the government;
- Raising public savings and as a result, national savings. By clearly assigning the reserve funds for future expenditure, the government may have to reduce current expenditure or raise taxes to maintain its fiscal objectives. Hence, the overall debt position of the government may improve.

Accessing output produced in foreign countries which may not be suffering the same demographic shock. Again, such objective could be met through other means, such as redirecting private savings towards foreign assets. A reserve fund, however, may be able to take a longer horizon on these investments, hence reaping greater benefits from international diversification of its investments.

³ The policy proposals considered in this report draw partly on the OECD Guidelines on Corporate Governance of State-Owned Enterprises (OECD (2005b)).

⁴ In order to offset demographic shocks, policies need to be guided primarily to increase the size and productivity of the working population.

In developing countries, where financial systems are underdeveloped, prefunding via reserve funds may also contribute to economic growth by improving access to finance for productive activities.

Around the world, countries have chosen different routes to prefund social security systems. Many OECD countries have recently established reserve funds, which complement a long tradition of pension fund provision. The situation varies widely across non-OECD countries. In Latin America and most countries in Eastern Europe, pension funds have been recently established, partly replacing the PAYG financing system. This is leading to a rapid accumulation of funds in these countries. In addition, a few non-OECD countries, primarily in Asia, have relatively large reserve funds that support their social security systems, but a rather small pension fund sector. Examples include China, Egypt, Jordan, Philippines and Saudi Arabia (see Blundell-Wignall et al (2008)).

In general, prefunding via pension funds is preferable to reserve funds, as the former guarantee ownership or beneficial rights to pension plan members and are normally subject to a comprehensive regulatory and supervisory framework. Moreover, the financial advantages of prefunding generally apply whether this takes place via pension funds or reserve funds. A preference for reserve funds may arise if there are cost or/and investment performance advantages over privately managed pension funds, something which is unlikely to happen in countries with poor public sector governance.

Historically, reserve funds were managed as part of the social security scheme (social security reserve funds or SSRF), where the legal or beneficial owner is the scheme itself. More recently, some governments have established autonomous reserve funds that are under its direct ownership but are legally assigned to support the social security system or more generally to address fiscal imbalances caused by demographic ageing (sovereign pension reserve funds or SPRFs).⁵

Table 1 shows the main SSRFs and SPRFs in OECD countries. The total assets managed by these funds equalled USD 4.1 trillion in December 2006. By far the largest reserve fund in the world is the United States' Social Security Trust Fund, with assets of over USD 2 trillion. However, all of its investments are non-tradable securities issued by the US Treasury. The second largest reserve fund is Japan's, with assets over USD 1.2 trillion in December 2006, the largest part of which is held at the Government Pension Investment Fund.⁶ The third largest is Norway's Government Pension Fund-Global, with assets approaching US\$280bn in December 2006, followed by Korea's National Pension Fund, with assets equal to US\$190bn. The Japanese reserve fund is larger than any pension fund in the world, while the Norwegian and Korean reserve funds also rank among the ten largest pension-related institutional investors in the world.

Table 1. Public Pension Reserve Funds in selected OECD countries

Country	Name	Type	Since	AUM (mn \$, 2006)
United States	Social Security Trust Fund	SSRF	1940	2,048,112
Japan	National reserve funds (incl. GPIF)	SSRF	1959	1,217,551
Norway	Government Pension Fund - Global	SPRF	1990	278,124
Korea	National Pension Fund	SSRF	1988	190,842
Sweden	National Pension Funds (AP 1-4 and 6)	SPRF	2000	117,468
Canada	Canada Pension Plan reserve fund	SSRF	1962	86,392
Spain	Social Security Reserve Fund	SSRF	1997	44,875

⁵ Some of these SPRFs, like the Norwegian Government Pension Fund are also often treated as a type of sovereign wealth fund.

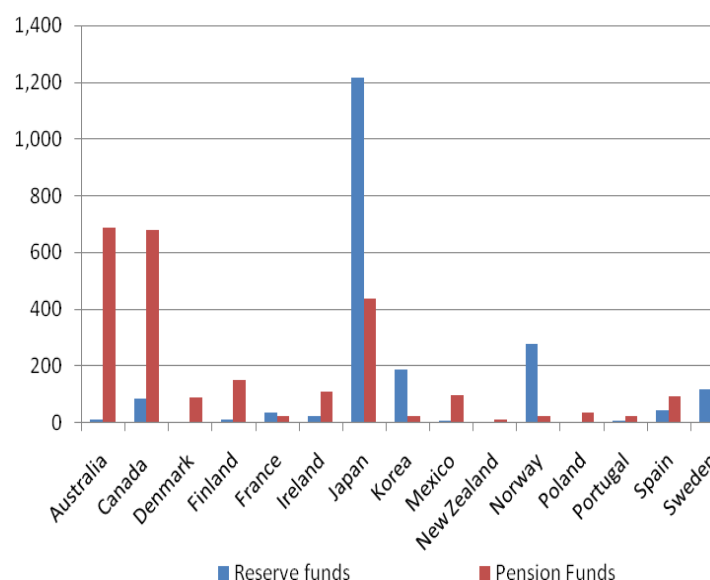
⁶ In March 2007, about one quarter of the Japanese reserve fund assets were held in deposits to the Fiscal Loan Fund. These funds are expected to be transferred to the GPIF by 2009.

France	Pension Reserve Fund (FRR)	SPRF	1999	39,140
Ireland	National Pensions Reserve Fund	SPRF	2001	23,710
Australia	Future Fund	SPRF	2006	13,678
Portugal	Financial Stabilisation Fund	SPRF	1989	8,330
Mexico	IMSS Reserve Fund	SSRF		7,392
New Zealand	Superannuation Fund	SPRF	2001	6,666
Poland	Demographic Reserve Fund	SPRF	2002	1,760
Denmark	Social Security Fund	SSRF	1964	659

Source: OECD (2007)

While at a global level, the wealth accumulated in occupational and personal pension funds (USD 16 trillion) is still much greater than that in public pension reserve funds (USD 4 trillion), the situation is the opposite in some OECD countries. In Figure 1, the assets accumulated in reserve funds are compared against those of pension funds. In a few countries (France, Japan, Korea, Norway and Sweden), reserve funds have actually accumulated more assets than pension funds.

Figure 1: Reserve funds and pension funds in selected OECD countries (USD bn, 2006)



Source: OECD (2007)

III. Recent evolution of reserve funds and outlook for the future

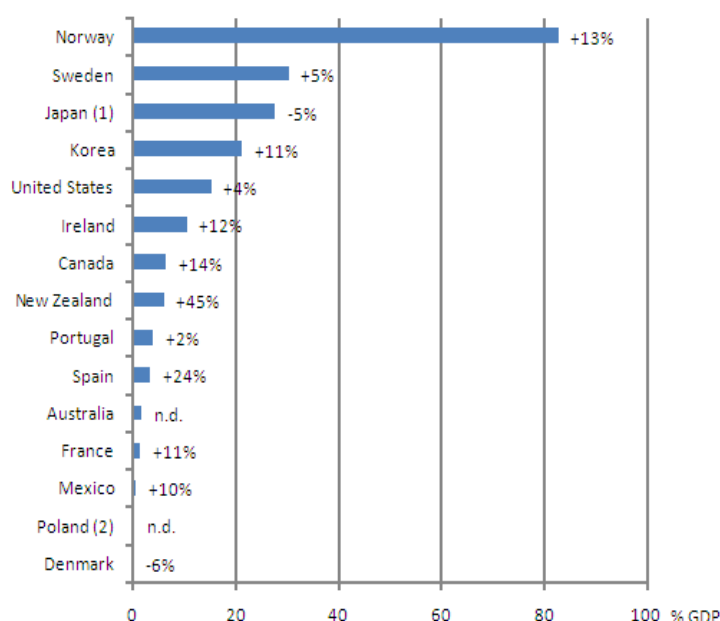
Unlike pension funds, reserve funds support what are otherwise PAYG-financed pension systems and are generally not expected to cover but a small part of the social security system's liabilities. For example, the Portuguese reserve fund (the so-called Social Security Financial Stabilisation Fund) is expected by law to receive every year between 2 and 4 percent of the obligatory contributions paid by employees to the social security system until it accumulates assets equivalent to two years of social security benefits. The fund was established in 1989 and by December 2006 had USD 8.3 bn in assets, equivalent to 5% of GDP. Sweden's reserve fund is actually a group of competing and independent funds (the AP-Fonden 1 to 4 and AP6) which were established in May 2000 from the existing ATP fund, which had been established in 1960.

Some of the more recently established reserve funds, which are also of the sovereign type, have grander ambitions. Examples of SPRFs that are destined to accumulate large assets include the following:

- *France's Pension Reserve Fund (FRR)*: The fund was set up in 1999 and by December 2006 had assets of USD39 (€31) billion. The part of the projected PAYG shortfalls that the Fund will finance from 2020 onwards will depend on the funding it will receive until this date. Up until now, the fund has been receiving a varying annual contribution from the government, ranging from €5.5 billion in 2002 to €1.5 billion in 2006. Financing comes from surpluses from the National Old Age Insurance Fund for Wage Earners, the Old Age Solidarity Fund, additional taxes on private assets, and contributions from savings banks and the Deposit and Securities Fund plus infrequent cash injections. Some funding also comes from asset sales: starting in 2000, the bulk of the revenue generated by the sale of licenses for third generation cellular telephones will also be transferred to the FRR.
- *Ireland's National Pensions Reserve Fund*: The National Pensions Reserve Fund Act that established the reserve fund in 2001 stipulates explicitly that utilisation of the fund to cover deficits in the social security system will only become possible from 2025 onwards. As the fund receives 1% of GNP every year from the government (until at least 2055, as stated in the National Pension Reserves Fund Act), it is expected to accumulate assets representing up to 45% of the country's GDP. At its founding in 2001, the fund also received part of proceeds from the privatisation of Telecom Éireann.
- *New Zealand's Superannuation Fund*: This fund was established in 2001 to partially provide for the future cost of superannuation payments. The government's annual contribution is determined by an actuarial formula (which is in the legislation) and is expected to average \$NZ 2.2 billion a year (around 0.75% of GDP) until 2025. The actuarial formula also determines the rate at which the government can draw down the funds, but no withdrawals are possible before 2020. In the drawdown period, expected to begin in 2028, the government expects to draw the equivalent of between 15 to 20 per cent of the annual cost of superannuation payments. In December 2006, the fund had NZ\$ 11.9 billion in invested assets (over 6% of GDP) and is expected to peak at around 33% of GDP in 2037.
- *Norway's government pension fund – global*: This fund, previously known as the Norwegian petroleum fund, was established in 1990. The name change occurred in January 2006. By law, transfers from the fund are limited to four percent of the capital a year, which is equal to the estimated long-term real rate of return from the fund. The fund already has assets representing 83% of the country's GDP in December 2006 and is projected to reach USD 800-900 billion in assets by 2017.

The rapid growth of SPRFs relative to SSRFs can be observed in Figure 2, which compares the largest reserve funds relative to GDP in each country. The two largest reserve funds in relative terms are of the SPRF variety. The highest rate of growth in 2005-6 was observed in New Zealand, followed by Spain, Norway, and Ireland, all of which, except Spain, are of the sovereign type.

Figure 2. Assets accumulated in reserve funds (as % of GDP and growth 2005-6)



Notes: (1) Japanese data is from fiscal year 2005-6. (2) Polish data refers to 2005.

Source: OECD (2007)

IV. The governance of 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.

Reserve funds, like pension funds, require a governance structure that ensures an appropriate division of operational and oversight responsibilities, and the suitability and accountability of those with such 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. At the centre of the governance structure is a governing body that has ultimate responsibility for the fund and is accountable to its beneficiaries. The members of this body must have clear fiduciary duties and a specific, measurable mandate, and must possess relevant expertise to be able to carry out their functions.

The governing body 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 may be preferable as a protection against political interference, especially if a government ministry is responsible for administering the social security scheme.

The governing body is to be assisted by an investment committee which advises on the investment strategy, and an executive that is in charge of operational management, including asset management. Asset management may also be delegated externally, but the governing body should retain the fiduciary

responsibility for the fund. Where the governing body does not possess sufficient knowledge to discharge its duties, it should also seek external advice.

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. 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.

Good governance also calls for effective mechanisms of internal and external control. 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, transparency and regular review and assessment. Control systems should include a code of conduct and mechanisms to address conflict of interest situations. Reserve funds should also be required to disclose publicly relevant information and should have procedures in place to address complaints from the general public.

While all these basic features of governance is common to both reserve funds and pension funds, reserve funds also face some unique challenges that call for greater care in the governance design and possibly additional constraints and requirements on the governing body and other parties that partake in the governance of the fund. The challenges specific to reserve funds include the following:

- Reserve funds are established by the government, the social security institution, or some other public sector entity. The government 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. This political risk, which also affects pension funds for government workers, can endanger the effective governance of the fund.
- Reserve funds are not usually subject to the supervision of an independent financial supervisory authority. The accountability of the governing body therefore relies on public disclosure of its operations (such as an annual report containing the accounts verified by an independent auditor) and any reporting requirements to the government, parliament or the public controller.
- 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.

Given these difficulties, reserve funds are in need of specific governance structures and mechanisms to protect them from political risk while ensuring their accountability to the general public. These additional features of reserve fund governance can be observed in a selection of reserve funds (both SSRFs and SPRFs) around the world, which rank among the largest in terms of assets as a percentage of GDP.

Legal separation and ring-fencing

From a governance perspective, the key difference between SSRFs and SPRFs is that the latter involves a strict legal separation of the reserve fund's assets from other assets of the social security system. As social security systems offer services other than pensions, such as health or family benefits, the mingling of reserve fund assets with other resources of the social security system can lead to misuse, such as a diversion of pension assets to cover deficits in non-pension branches of social security.

While this justification has some merit, legal separation is not as critical as it is in the case of pension funds, where it is used to protect pension assets from company insolvency. Regardless of whether the reserve fund is legally separated from the scheme, the legal title to the assets is by necessity in the hands of the public sector. In the case of a SSRF, the social security institution holds the legal title to the assets, and hence the government is an indirect owner. In the case of a SPRF the government holds directly the legal title to the reserve fund's assets. Yet, the government can also be tempted to use the funds for other purposes than pension financing.

Hence, rather than requiring the legal separation of the reserve fund from the social security institution, what is essential is to ensure that the fund is used only for pension financing. This can be achieved via so-called "ring-fencing", which in the case of a reserve fund consists in laws stating that the assets of the reserve fund are to be used exclusively for the payment of pensions. Such laws are applied to some SSRFs, such as the Canada Pension Plan reserve fund, while most SPRFs are subject to them. The main exception is Norway's Government Pension Fund, which actually consists of two funds: a "Global" one invested exclusively abroad and financed from oil revenues (formerly, the Norwegian Petroleum Fund) and a "Norway" one that invests mainly domestically (formerly, the National Insurance Scheme Fund). Its founding act states that it "shall support central government saving to finance the National Insurance Scheme's expenditure on pensions and long-term considerations in the application of petroleum revenues." The broader mandate, while granting flexibility to the government's fiscal objectives, obscures the financing of the social security system.

The governing body and the management entity

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. Under the SSRF structure, the governing body is typically the tripartite board of the social security institution, whose members are selected by the government, and representatives of employers (e.g. employer associations) and workers (typically labour unions). There are, however, some exceptions. In Canada, for example, the reserve fund is under the direct responsibility of the board of a Crown corporation, the Canada Pension Plan (CPP) Investment Board. In Korea, the reserve fund is under the direct responsibility of the National Assembly and the management entity is the National Pension Service, Korea's social security institution.

Under the SPRF structure, the governing body is either an independent committee (like the National Pensions Reserve Fund Commission in Ireland) or the highest organ of an independent legal entity that is exclusively responsible for the management of the reserve fund (like the Board of the Guardians of New Zealand Superannuation). Japan and Norway are the main exceptions to such an arrangement. In Japan, the investment strategy, one of the key responsibilities of the governing body, is decided by the Ministry of Health, Labour and Welfare, after consulting with the chairman and investment committee of the

Government Pension Investment Fund. In Norway, the fund is directed by parliament, which sets out the investment guidelines, and the Ministry of Finance. The fund's assets are invested by the asset management subsidiary of the Central Bank (Norges Bank Investment Management).

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 segregated governance model of reserve funds 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:

- 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.
- 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.
- 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.
- 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.

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 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.

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.

As the governing body of most SSRFs is the tripartite board of the social security institution, the lack of experience and knowledge of these representatives in financial matters can be a cause of concern. 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.

Professional eligibility requirements for members of the governing body are in place in all countries with SPRFs. As shown in Table 3, the strictest requirements are in place in New Zealand, where all board members must have experience, training and expertise in investment management.

The nomination of the members of independent governing bodies varies between countries, but a key feature in some countries (e.g. Canada and New Zealand) is the appointment of a nomination committee that is in charge of selecting candidates for the governing body. The selection is made by the government from this list, ensuring greater independence in the selection process from political influence. This is especially the case in New Zealand as at least four of the members of the nominating committee must have work experience qualifying them as investment professionals. In Canada, on the other hand, the nominating committee is made up of representatives of the federal and provincial governments (one from each jurisdiction).

Termination clauses are also important to avoid the capricious dismissal of members of the governing body by government. In Canada, for example, CPP Investment Board directors may only be removed “for cause”. Commissioners of Ireland’s NPRF may be removed for misbehaviour, or because his or her removal appears to the Minister to be necessary for the effective performance by the Commission of its functions. In the other countries, there are few if any restrictions on the government’s ability to dismiss board members.

Table 3: Selection of the governing body of reserve funds

Country	Fit and proper criteria	Nomination	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 years 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	Members are appointed by parliament (two), the senate (two), various Ministries (four), trade unions (five) and employer and self-employed	Members that are not appointed by governmental authorities have 6 year terms.	

	FRR's stated missions.	associations (five).		
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, or is disqualified or restricted from being a director of any company.	Commissioners are appointed by the Minister of Finance, except the CEO of the management entity, who is an ex-officio 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 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 three-year 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.

The effectiveness of the governing body in accomplishing its duties also depends on its size, working methods and voting procedures. Most of the governing bodies covered in this study have fewer than 15 members, ranging from 7 in Ireland and New Zealand to 20 in France. In between are the Canadian reserve fund (12 members), the Japanese (11 members) and the Swedish (9 members). Voting is by simple majority with the chair having a casting vote in case of a tie.

Good governance also requires a clear assignment of responsibilities between the governing body and the fund's executive. 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. The top executives, having been elected for their expertise in investment matters, need to have their incentives aligned by a strong, independent board that looks after the fund's mission. The reserve funds surveyed have achieved a clear separation between executive and oversight responsibilities. This is most evident in countries where the reserve fund's governing body is not part of the management entity (e.g. Korea, Ireland and Norway), but is also the case in the other countries surveyed as there is no overlap in the membership of the governing body and the executive team.

But 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.

The composition and organisational structure of the executive also matters greatly for the successful deployment of a fund's resources. 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, but only some reserve funds have them. Reserve funds that have appointed CIOs in addition to CEOs include the French and New Zealand reserve funds. It is also good practice for the reserve fund's top executives to meet regularly. The French FRR, for example, has established an executive board made up of the top three executives in the organisation.

The investment committee

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 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.

Most of the reserve funds covered in this study have investment committees. Most also have fewer than 10 members, but there are some exceptions, like the Japanese with 11 members and the Korean one which has 21 members, consisting of:

- Chairman (Minister of Health and Welfare).
- Five vice-ministers of government
- President of the Korea National Pension Service.
- Twelve representatives of employers, labour and consumer groups.

- Two experts with knowledge about pensions.

This complex and highly political composition contrasts with the situation in a country like France where the investment committee consists of only 5 members, including a member of the Executive Board. The other four members are individuals with the requisite professional credentials, and are appointed by the Executive Board. Its mandate is to assist the Executive Board in the task of screening investment firms being considered for asset management mandates.

Remuneration, code of conduct and conflicts of interest

Remuneration policies vary across reserve funds. For example, the members of the supervisory board of the French FRR serve on a voluntary basis. On the other hand, board members of the Swedish AP Fonden are remunerated according to government policies.

A written code of conduct is also part of the best practice requirements for reserve funds or their managing entities. Canada's CPP Investment Board is required to implement and disclose a code of conduct, including tight controls on the personal investing of directors and employees and a requirement to report any attempted political influence of investment decisions. The code of conduct is based on a duty of care and a duty of loyalty. Such duties as expressly mentioned in the Japanese reserve fund's statement of investment principles.

In New Zealand and Ireland guardians/commissioners must follow a code of conduct and must disclose any conflicts of interest they may have. In Ireland, "*commissioners and members of the staff of the manager or committee must disclose to the Commission (or manager or committee) any pecuniary or beneficial interest in and material to any matter considered by the Commission*" (Section 12(1), NPRF Act, 2000). The Act further requires that any conflicted person:

- Can neither influence nor seek to influence a decision to be made in relation to the matter
- Can take no part in any consideration of the matter
- Where relevant, must absent himself/herself from the meeting or part thereof during which the matter is discussed
- Where relevant, cannot vote on a decision relating to the matter.

Not all reserve funds are required to establish a code of conduct. However, conflicts of interest are still regulated. For example, the Act establishing the Swedish AP funds requires members of the board of directors to refrain from participating in meetings regarding agreements between the fund and third parties in which the member has a material interest or legal entities which the member is authorised to represent.

Internal control, independent audit and custody

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. Management entities of reserve funds that must have an audit committee include Canada's CPP Investment Board, while both the Irish NPRF's Commission and New Zealand Superannuation Fund's Board of Guardians decided to establish an audit committee soon after their start of operations.

An independent annual audit of the reserve fund is also a standard practice among reserve funds and consistent with OECD and ISSA Guidelines. All reserve funds or/and management entities surveyed are

subject to such a requirement. For example, the CPP Investment Board is subject to an annual financial audit by an external auditor and every six years there is a special examination of investment practices. In Ireland, an independent audit of the NPRF is carried out annually by the Comptroller and Auditor General. In Sweden, the government appoints two auditors to each AP Fund, one of whom is common to all the funds. The auditors must be authorised public accountants and must be changed every three years. The French FRR is audited annually by the Audit Office (Cour des Comptes). The Norwegian Government Pension Fund is audited by the Office of the Auditor General.

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. Reserve funds that require the appointment of a custodian include the French FRR (by the *Caisse des dépôts et consignations*, a public sector financial institution) and the Irish NPRF.

Public disclosure and external supervision

The accountability of the governing body calls for regular reporting of its activities to the relevant government authority and the public at large. 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

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 important that management fees are accurately measured. In some cases, like Ireland, all expenses (including those of the Commission, investment manager, custodian, consultant or any other service provider engaged by the Commission) shall be charged on and paid out of the Fund. Where only some expenses are charged to the fund, the additional costs should be disclosed by the relevant body.

Other documents that are published by some reserve funds are the statement of investment principles and the code of conduct. For example, The Canadian CPP Investment Board and Irish Pension Reserve Fund are required to publish their statement of investment policy, governance structure, quarterly financial statements (CPP Investment Board only) and annual reports (including performance assessment).

Other than the independent audit and the disclosure of the annual report and other relevant documents to the public, additional oversight may be exerted by relevant public entities and parliament. For example, the French FRR is subject to the control of the General Inspectorate of Social Affairs and the General Finance Inspectorate; in addition to the Audit Office (Cour des Comptes). The Japanese GPIF must present its independently audited financial statements to the MOHLW for approval. After approval, the GPIF discloses the accounts to the general public. The GPIF also discloses publicly on a quarterly basis the result and status of its investments. The Swedish government must make an evaluation of the management of the AP Fund assets and submit it to the parliament together with the funds' annual reports. Similarly, the Norwegian Government Pension Fund's reports are submitted to parliament for discussion.

Policymakers may also consider bringing reserve funds under the purview of the pension fund supervisory authority as is the case in some non-OECD countries (e.g. Costa Rica, Kenya, and it has also been recently proposed in Chile). Supervision by the pension fund authority can ensure independent, efficient supervision by an authority with expertise in fund management issues.

V. Investment management of reserve funds

Mission and objectives

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. With the single exception of the Norwegian Government Pension Fund, all the reserve funds surveyed in this report have clear mandates, focused exclusively on the financing of public pension expenditures. However, not all reserve funds have sufficiently specific investment objectives allowing them to determine an appropriate investment strategy.

Reserve funds require a specific investment goal, which is usually defined as a rate of return objective (and associated risk) over a certain time horizon. As the purpose of reserve funds is to help meet future pension liabilities, there is a need for a clear return objective derived from the actuarial calculation of the future cashflows of the social security system. Among the reserve funds covered, most have a mission statement, but only three (Canada, Japan, and New Zealand) have stated a specific rate of return objective.

In Canada, the government has set a funding ratio (ratio of public pension assets to liabilities) and a rate of return target (and time horizon) for the CPP reserve fund. The fund targets a 4.2% real rate of return (in order to increase the funding ratio from 8% to 25% by the year 2025), which is based on the yield on long term government bonds in real terms plus a 2.3% premium for equities.

The French FRR was established for the purpose of “contributing to the long-term sustainability of the PAYG pension plans”.⁷ The fund receives various contributions from the government, including part of the social solidarity contribution, and part of the surplus of the old age solidarity fund. Disbursements cannot be made until 2020.

In Ireland, the NPRF’s explicit aim is tax-smoothing, covering future deficits in the pension system. No money can be withdrawn before 2020. Its mission, set out in the National Pensions Reserve Fund Act’s Art. 18(1) is “...meeting as much as possible of the cost to the Exchequer of social welfare pensions and public service pensions to be paid from the year 2025 until the year 2055, or such other subsequent years”.

The Japanese GPIF is required to develop an investment strategy that will attain a long-term rate of return sufficient to maintain a stable ratio of reserves to annual public pension expenditure. The performance goal is set by the Ministry of Health and Welfare and written into the fund’s medium-term plan. The GPIF has a long-term real rate of return target of 2.2% p.a. (3.2% nominal), or 1.1% p.a. above the assumed rate of growth of wages.

The New Zealand Superannuation Fund is required to facilitate tax smoothing over a forty-year period. By law, the government’s contribution rate is linked to the fund’s performance and there can be no withdrawals from the fund before 2020. Its investment goal (set by the “Guardians”, the governing body of

⁷ Act No. 2001-624 of July 17, 2001, amended by Act No. 2003-775 of August 21, 2003, on the reform of pensions, codified in the Social Security Code, in Chapter V bis entitled Fonds de réserve pour les retraites in Articles L135-6 to L135-15.

the fund) is to exceed, before New Zealand tax, the interest rate on New Zealand Treasury bills by at least 2.5% p.a. over rolling 20 year periods.

In contrast the requirements on the Korean National Pension Fund and the Swedish AP Funds are relatively sparse. The Korean fund is managed and run “for the purpose of maintaining and increasing the value of the fund in order to achieve the long-term stability of the fund”.⁸ The fund’s investment policy statement defines a long-term goal to align its return with the pace of GDP growth. The Swedish AP Funds are required to manage assets so as to achieve the greatest possible return on investments, but “total risk levels must be low”.⁹ A similarly vague investment objective is applied to the Norwegian Government Pension Fund, which is expected to achieve a “high financial return subject to moderate risk”. However, the government’s planned withdrawal of 4% of the fund is based on its expectation of the fund’s long-term real rate of return, so this level of investment return has effectively become the Fund’s target.

Statement of investment policy and portfolio limits

Most countries require the reserve fund to have a written statement of investment policy and to review it regularly. As a minimum such statement covers:

- 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.

The investment strategy is set out by the fund’s governing body. In countries where this body is housed in a government ministry or parliament, like Japan, Korea and Norway, there is greater scope for political influence on investment decisions and in particular for investing the fund for macro-stability or developmental goals. For example, in Korea and Japan, the government has in the recent past pressed their respective reserve funds into buying shares to support the stock market at times of financial weakness, such as during the 1997-8 Asian financial crisis. Before its 2001 reform, the Japanese reserve fund was also largely used to invest and lend money to government agencies for public works in the country. Until 2000, the Korean fund was also required to deposit part of its annual receipts with a government agency to invest in rural areas, infrastructure and for providing loans to the poor and small companies.¹⁰ The fund also has a small “welfare sector” investment allocation (less than 0.5% of assets), which includes direct loans to individuals for housing and schooling and lending for building recreational and care facilities for senior citizens, children, and the disabled.

One of the most remarkable aspects of the regulatory environment of the reserve funds surveyed is that with the exception of Ireland, Japan, Korea, and Sweden there are no major investment limitations. The only quantitative investment limit applied to the Irish NPRF is the prohibition to invest in Irish government securities. The Japanese GPIF’s investments are mainly restricted to domestic listed equities and bonds, though this is the outcome of the medium term investment plan developed by the GPIF and

⁸ Quoted from the 2004 Annual Report on National Pension Fund Management.

⁹ Quoted from the Law Establishing the AP Funds.

¹⁰ The allocation to this public agency was reduced sharply from 71.5% of total assets in 1998 to 4.8% in 2004.

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. 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). A similar situation exists in Korea, where the National Pension Fund's investment committee develops an investment policy that ultimately needs to be approved by the National Assembly. The asset allocation has become increasingly diversified over time and since 2003 includes foreign securities and alternative investments. By 2009, the overseas asset allocation and the alternative investments allocation are to be raised to 12% and 3% of the fund, respectively.

The following restrictions by asset class are applied to the Swedish AP Fonden since 2001:

- Only investments in capital market instruments which are quoted and marketable are permitted. Direct loans are prohibited.
- No more than 5% of the funds' assets may be invested in unlisted securities. These investments must be made indirectly via portfolio management funds or similar.
- At least 30% of the funds' assets must be invested in low-risk interest-bearing securities.
- No more than 40% of assets may be exposed to currency exchange risk.

The reserve funds in these countries face additional restrictions intended to ensure diversification or to avoid direct control of corporations by reserve funds. The Irish NPRF is prohibited from controlling any company or hold such percentage of the voting rights in any company that would require it to seek control of that company. The Japanese GPIF's investment policy 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. 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. Similar restrictions are applied via legislation to the Swedish reserve funds:

- No more than 10% of a fund's assets may be exposed to one issuer or group of issuers.
- Shares held in listed Swedish corporations may not exceed 2% of total market value.
- Each fund may not own more than 10% of the votes of in any single listed company.

Some of the reserve funds in other countries face prudential restrictions of this same nature (diversification and ownership limits), but in most cases these are imposed by the funds themselves. The main case of a legislative or governmental limit is the ceiling of 5% on the Norwegian Government Pension Fund's ownership of a stake of any company. This ceiling is established by the Ministry of Finance and was raised from 3% in 2006.

Socially responsible investment

Socially responsible investment (SRI) is also an area of increasing interest among reserve funds. SRI involves assessing extra-financial risks in investment decisions, in particular those related to environmental, social and corporate governance factors. In its origins, SRI focused primarily on ethical factors, but such considerations are now treated separately from the more objective concerns over environmental impact or corporate governance practices. Nonetheless, some reserve funds, like Norway's

Government Pension Fund, puts a strong focus on ethical investment, and in particular, weapons manufacturing.

The implementation of SRI policies has traditionally relied on a screening mechanism, where either “non-compliant” companies were excluded from a portfolio (negative screening) or where companies seen to be socially responsible were selected for inclusion in the fund (“positive screening”). These approaches have been superseded in recent years by a shareholder engagement approach which seeks to change company behaviour via the exercise of voting rights and other mechanisms of corporate governance. This approach is also favoured by the UNEP FI’s Principles of Responsible Investment, to which various reserve funds are signatories.

Some reserve funds still use a negative screening approach to SRI. Norway’s reserve fund, for example, has been applying a selective negative screen which has led to the exclusion of many large companies, including well-known firms such as Wal-Mart, EADS, Lockheed Martin, Hales, BAE Systems, Boeing, Finameccanica and Honeywell International because of their involvement in weapon manufacturing. Wal-Mart was later excluded because of violations of basic labour rights. In September 2006, Sweden’s AP2 fund followed the Norwegian reserve fund’s example and decided to liquidate its Wal-Mart holdings.

Other reserve funds have specifically incorporated SRI criteria into their investment policy or engaged part of their portfolio in this manner. These include the Canadian, French, Irish, Swedish and New Zealand reserve funds. Six of the eight reserve funds surveyed are also signatories of the UNEP FI’s Principles of Responsible Investment (Canada, France, Ireland, New Zealand, Norway and Sweden).

Asset allocation and performance

While some of the older reserve funds surveyed started operations with conservative portfolios, invested mainly or solely in fixed income securities or loans to public entities (Canada, Korea, Japan and Norway), investment policies have rapidly veered in recent years towards equities and other asset classes in the higher risk-return spectrum, including in some cases private equity, hedge funds, commodities, and other alternative investments (see Table 3). The more recently funds (France, Ireland, New Zealand and Sweden) have all started with diversified portfolios that included at least a sizeable allocation to equities.

Some PPRFs are also increasing their allocation to foreign assets, though this information is not readily available for some funds. Countries with high foreign investment allocations in their reserve funds in 2006 include Norway (the Government Pension Fund – Global is fully invested overseas), New Zealand (75.9% overseas investment), Ireland and France (35.4% and 29% of total assets, respectively, invested in non-euro assets). On the other hand, foreign assets account for only 9.6% in Korea and 25.5% in Japan.

Table 4. Asset allocation information of PPRFs in 2006

		EQUITIES	BONDS	CASH	PROPERTY	ALTERNATIVE INV.
OECD	Canada	58.5	31.8	0.6	4.6	4.5
	France	62.1	26.4	11.5		
	Ireland	77.1	13.3	4.7	3.0	0.6
	Japan	37.3	62.7	0.0		
	Korea	8.9	89.3	0.4		1.2
	New Zealand	60.0	20.1		7.2	12.7
	Norway	40.7	59.3			
	Sweden	59.5	36.7	0.8		

Note: "Alternative investments" refer to "private equity" for Canada and Ireland, while that for Korea and New Zealand refers to various alternative asset classes. Data for Japan refers to the GPIF.

Source: Blundell-Wignall et al. (2008).

Information on gross and net of fees performance in recent years is also readily available from the reserve funds' respective annual reports, but it is not always clear whether all investment management fees are deducted. All countries use a market valuation approach, but there are some differences in the methodology calculating for rates of return. An assessment of investment performance is however difficult since half of the funds surveyed were established after 1999 while those that were established earlier (e.g. Canada, Japan, Korea and United States) do not have readily accessible statistics on historical performance. The feasibility of such an exercise is also questionable given that these funds were historically invested only in loans to public agencies or non-marketable government bonds.

The information on performance reported by the funds in recent years shows that on average they have been able to meet their long-term return targets and have also done better than their market benchmarks, even after taking management fees into account. Overall, therefore, both in terms of transparency and management efficiency the assessment is generally positive (see Vittas et al. (2008)).

Asset management

Policies in the implementation of asset management vary across reserve funds. Some, like the French and Irish reserve funds are required to fully externalise their asset management. In the case of the Swedish AP Fonden, at least 10% of assets must be managed by external fund administrators. This decision can be explained by the government's wish to isolate the funds from political pressures.

On the other hand, a few reserve funds are large enough to allow them to carry out a significant part of their investment in-house. Three noteworthy cases are the Norwegian Government Fund which carries out 80% of its asset management in-house (by Norges Bank Investment Management), the Korean National Pension Fund, with 90% in-house management, and the Canadian reserve fund. The CPP Investment Board also has a series of units in charge of investments in specific areas such as private equity, real estate and infrastructure.

The Japanese GPIF, despite its size, relies to a large extent on external asset managers for its non-debt and foreign investments. It reviews the composition of external asset managers (manager structure) once every three years and invests largely in a passive manner, tracking market indices. The weight of passive to total investment ranged from 72% for the foreign bond portfolio to 80% for the foreign equity portfolio in March 2007.

VI. Conclusion

The public pension reserve funds reviewed in this report can be considered to be largely compliant with OECD standards of good pension fund governance and investment management. In particular, the requirements of accountability, suitability and transparency are broadly met by these reserve funds. However, some specific details of the fund's governance structure and investment management could be improved to better isolate them from undue political influence, ensure a level-playing field in the institutional investment market, and to enhance the expertise in the management of the funds.

The following can be considered international examples of good governance and investment management of reserve funds, complementing those required by the OECD and ISSA guidelines:

- Reserve funds should be under the ultimate oversight responsibility of a board (the governing body) composed of members with the necessary collective investment knowledge and experience to carry out their functions effectively. Board members should be appointed following a transparent selection and nomination process. The reserve fund's board may be an independent committee or the board of the management entity in charge of the operation of the reserve fund.
- Reserve funds should be served operationally by an autonomous management entity, dedicated exclusively to the administration and investment of the reserve fund assets. Where such separation cannot be guaranteed, there should be a department in the management entity exclusively dedicated to the reserve fund.
- Where justified on economic grounds (e.g. for small funds and special asset classes such as alternative investments), reserve funds should aim to carry out as much as possible of their investment via external asset managers, selected where relevant (mandates) via a competitive bidding process.
- 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.
- Legal investment restrictions should be limited to those concerning basic diversification, such as exposure to single issues or issuers. 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.
- 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. Other documents that should be publicly disclosed are the statement of investment policy and the code of conduct. Additional oversight may be exerted by relevant public entities (for example, the pension fund supervisory authority) and parliament.

The study has revealed that the reserve funds surveyed follow most of the practices above. In particular, there is a high degree of public disclosure and oversight by parliament or public sector entities and relevant experience requirements on board members, though these vary across countries. There are

only a few exceptions to this generally positive assessment. For example, the Korean and the Norwegian reserve funds are under a governing body housed in a ministry, rather than under an independent committee or the board of an autonomous management entity. The asset allocation of the Japanese reserve fund (the GPIF) is also decided by a Ministry, rather than the GPIF's board. In the other countries surveyed, the governing body is either an independent committee or the board of an autonomous management entity, and its members are required to have some expertise and knowledge in investments and fund management.

The absence of an arms-length relationship between the government and the reserve fund's governing body can also facilitate political interference in the management of the fund. Both the Japanese and Korean reserve funds have been used in the past for financial stability and developmental goals that may come into conflict with their stated objective to achieve a good investment performance in order to improve the financing of the pension system.

Norway is the only country surveyed whose fund does not have an exclusive mandate to finance public pension benefits. The flexibility retained by the government, while possibly necessary as far as government fiscal objectives are concerned is not conducive to better predictability of the fund's outflows and hence limits the board's ability to set clear investment objectives.

Investment objectives are most clearly defined in a few reserve funds that have set specific investment return targets, allowing a better monitoring of the fund's performance and enhancing the accountability of the governing bodies of these funds. Such practice should be more widespread than is currently the case.

Quantitative investment restrictions are also applied in some countries. Some of these can be justified on prudential grounds (e.g. limits on investment in singles issues and issuers) or as a way to limit the direct control of companies by these public sector entities (e.g. limits on control of company votes or ownership of a company's shares). However, legislation in Sweden actually sets broad asset class limits and even a floor on fixed-income securities, a practice that is discouraged by the OECD Guidelines on Pension Fund Asset Management. In countries such as Korea, Japan and Norway where the ultimate decision-making body is a government ministry or parliament, changes in the fund's investment policy can also become mired in political debate.

Reserve funds make a great use of external asset manager, reducing the possible concerns over political influence and public control of private companies. However, for some of the larger funds, the direct investment of part of the portfolio is an inevitable consequence of the attractions of economies of scale.

Overall, therefore, the OECD reserve funds surveyed show relatively high levels of governance and investment management, but there are some important differences across countries and areas where a strengthening in governance and investment management practices is called for. Further research could be conducted to assess the impact of any identified weaknesses on the fund's operation and in particular on its investment performance. It would also be valuable to extend the analysis to non-OECD countries.

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