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ABSTRACT/RÉSUMÉ

Reform on Pension Fund Governance and Management: The 1998 Reform of Korea National Pension Fund

This paper provides a detailed chronological account of the governance-cum-management reform of National Pension Fund in Korea and analyzes its success factors, drawing lessons for other countries. A review of the current governance structures with the fund versus OECD guidelines and international good practice is also provided, along with suggestions for further reform.

JEL codes: G18, G23, G28

Key words: *National Pension Fund, Korea, OECD, governance, public pension reserve funds*

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REFORM ON PENSION FUND GOVERNANCE AND MANAGEMENT: THE 1998 REFORM OF KOREA NATIONAL PENSION FUND

By Woochan Kim and Fiona Stewart¹

I. Introduction

During the past two decades, Korea went through an irreversible process of political *democratization* and *market-oriented economic reform*. The authoritarian government's submission to the democratization movement in June 1987 and the outbreak of financial crisis in November 1997 were the key triggering events. But, it was in December 1997, when these two movements elevated to become the nation's top agenda. Immediately after confirming his victory in the presidential election, Kim Dae-jung delivered a speech and declared that he will pursue democracy and market economy in parallel.²

The reform of Korea National Pension Fund (hereafter "NPF") in 1998 is one of many reforms that took place during the early years of Kim Dae-jung's presidency. The reform, however, is interesting in a sense that it is driven by both principles at the same time: democracy and market economy. The reform democratized the management of NPF by filling majority of seats in the NPF Management Committee with non-government civilians representing pension policyholders. The reform also abolished the practice of NPF surrendering pension surplus into the hands of government bureaucrats. With the reform, surplus funds are now invested in the market and significant portion of the fund is managed by external managers in the private sector.

The objective of this paper is to give detailed chronological accounts of this governance-cum-management reform of NPF and to analyze its success factors, hoping to draw lessons for other countries. It is worth noting that the reform this paper focuses is limited to governance and management reforms. In other words, financial sustainability issues relating to the Korea National Pension System are not covered. According to the latest projections by the Ministry of Health and Welfare (hereafter "MOHW") in 2008, NPF – the reserve fund of National Pension System – is expected to grow substantially, peaking in 2043,

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² His views on democracy and market economy can also be found from his 1999 Liberty Medal acceptance speech. Visit http://www.constitutioncenter.org/libertymedal/recipient_1999_speech.html

and then shrink rapidly, completely depleting in 2060. A very brief discussion on this issue is provided in the next section.³

Although, the governance and the management issues of reserve fund are secondary to the financial sustainability issue, they are important policy agenda in and of themselves. First, better governance and management structures can improve the returns on NPF and this, in turn, can postpone the year of its complete depletion.⁴ Second, by limiting the amount of funds government can borrow from NPF, governance and management reform measures can act as a fiscal disciplinary mechanism against the government. A strong fiscal position will become critical in later years when NPF gets completely depleted and Korea needs to proceed to a pay-as-you-go system. Third, a mega-sized fund with a long investment horizon following global best practices in investment management can have a positive spillover effect to the local asset management industry. For example, external managers complying with the investment performance reporting standards set by NPF and new types of asset management companies emerging with NPF's increased investment in alternative asset classes are just a couple of examples. Fourth, a governance environment that mandates NPF to solely pursue the best interest of its pension participants/recipients can place NPF in a better position to engage in shareholder activism, which, in turn, improves the governance of public corporations in Korea.

OECD also takes the matter of pension fund governance seriously, and in 2002 adopted the OECD Guidelines for Pension Fund Governance.⁵ The International Social Security Association (ISSA), which is an international organization bringing together national social security administrations and agencies, also adopted its own guidelines in 2004 (Guidelines for the Investment of Social Security Funds). In 2008, countries with sovereign wealth funds and the IMF announced the Generally Accepted Principles and Practices (GAPP) – also known as the Santiago Principles – for sovereign wealth funds, which include sovereign pension reserve funds.

This paper is organized as follows. Section 2 gives an overview of the National Pension Scheme. Section 3 gives chronological accounts of the 1998 reform, and section 4 discusses the success factors. Section 5 goes over the remaining issues, Section 6 provides a review of NPF governance versus OECD guidance and Section 7 concludes.

II. Overview of National Pension Scheme

Origin

The history of National Pension Scheme in Korea dates back to December 1973 when the Park Chung-hee administration enacted the National Welfare Pension Act. This is quite surprising given that there was no social pressure to introduce social insurance in Korea back then. People over 65 accounted for only 3.3 percent of the total population in 1970.⁶ According to Kim (2008), the idea of introducing a national pension scheme caught the interest of President Park because it was understood as a vehicle to mobilize domestic capital much needed to financially support his industrial policy targeting heavy-

³ For more detailed discussion on financial sustainability issues, see Kim and Kim (2005).

⁴ According to the projection by MOHW (2008), a 1%p increase in return can postpone the year of complete depletion by nine years. The depletion year of 2060 is based on the assumption that the return on NPF equals (1.1 x domestic interest rate). Given the fact that NPF will invest in overseas assets, the assumption on NPF return might be overly conservative.

⁵ See (OECD 2009)

⁶ See Min et al. (1986).

equipment and chemical industries.⁷ It is interesting to see government's temptation to misuse pension reserve money dates back so many years. It was the 1998 reform that challenged this long-standing view and prevailed over it.

The Act, which was promulgated in January 1974, however, was suspended ten days later with the Emergency Measure No.3.⁸ The oil shock of 1973/74, the double-digit inflation rate, and the economic stagnation formed an environment unfavorable to implement the Act. Also, in 1973, North Korea announced a plan to abolish its income tax from March 1974. This further made the implementation unattractive to the president who was in competition with the North Korean regime.⁹ Moreover, under the scheme adopted in 1973 with low contribution rate and narrow mandatory coverage, it was projected that the size of domestic capital the scheme can mobilize will be limited, which undermines the original purpose of introducing national pension. The main contents of the suspended National Welfare Pension Insurance Act, however, were greatly reflected later in the National Pension Act, which was enacted in December 1986.

During the first half of 1980s, the socio-economic environment changed and it became much favorable to adopt a national pension scheme. Inflation rates curbed, the economy boomed, and the baby boom generation started to enter the working force. After two years of preparation, in 1986, the government came up with its proposal and the bill to enact the National Pension Act passed the National Assembly in December 1986.¹⁰ The scheme was implemented a year later in January 1988.

Key Features

The Korea National Pension Scheme has a number of features worth noting.¹¹ First, it is a universal pension scheme. It covers any resident in Korea from 18 to less than 60 years of age, regardless of their income level and their occupation, with the exception of military personnel, government employees, and private school teachers that have their own occupational pension schemes.¹² Enrollment is also compulsory. Second, it is a defined-benefit scheme, the pension benefit of which is not influenced by the investment performance of pension reserves, but by the level of inflation-adjusted monthly income of its pension participants. The current replacement rate is 50 percent. This is scheduled to drop down to 40 percent by 2028.

Third, it is a mono-pillar scheme, which integrates the basic pension (income redistribution component) and the earnings-related pension. Pension benefit is a function of (i) average monthly income of the pension beneficiary concerned during the entire insured period adjusted into the value of the year prior to pension payment (earning-related component) and (ii) monthly income averaged across all pension participants during three years prior to pension payment (income redistribution or basic pension

⁷ This idea first came from Korea Development Institute (KDI) in its report in November 1972. In earlier years, KDI was a think tank of the Economic Planning Board (EPB).

⁸ Initially, it was suspended for one year, and then another year in December 1974, and indefinitely in December 1975.

⁹ With Emergency Measure No.3, President Park lowered the income tax rate.

¹⁰ Again, KDI was instrumental in designing the pension scheme. The initial scheme was drafted jointly by MOHW and KDI.

¹¹ See Kim and Kim (2005) for the details.

¹² Korea has three occupational pension schemes: Military Personnel Pension Scheme (MPPS), Government Employee Pension Scheme (GEPS), and Private School Teachers Pension Scheme (PSTPS).

component).¹³ Fourth, it is a partially-funded scheme, which has a reserve fund that will not last indefinitely. As mentioned earlier, NPF is expected to grow substantially, peaking in 2043, and then rapidly shrink, completely depleting in 2060. Without any major change in the scheme, Korea would have to proceed to a pay-as-you-go system. Until then, pension benefits will be solely financed by contributions paid by its members. Contribution rate for workplace-based insured persons is currently 9.0%, of which half is paid by the employees and the remaining half is paid by the employers.¹⁴ With the exception of farmers and fishermen, individually insured person pay the 9% contributions themselves.¹⁵

Sustainability Issue

The Korea National Pension Scheme was not designed to be a fully-funded scheme. Policy makers in the mid 1980s knew that the reserve fund – National Pension Fund – would be depleted in the future with the retirement of baby boom generation, the rise of life expectancy, and the drop in birth rate. According to the KDI report published in 1986, it was projected that the fund would peak in 2033 and then completely deplete in 2049.¹⁶ According to the most recent projection in 2008, the fund peaks in 2043 (2,607 trillion won) and then completely depletes in 2060. The evolution of fund size can be seen in **Figure 1**. Despite this sustainability problem, the original designers of the scheme set the contribution rate low (3% in the beginning and 9% at present), compared to the level of replacement rate, to alleviate any resistance during the first few years of NPS, the enrollment of which is compulsory.¹⁷ According to one recent study, the cost-benefit ratio of National Pension Scheme is greater than 1, regardless of the insured person's income level. The ratio ranges from 1.9 to 7.3, the ratio increasing with lower income.¹⁸

¹³ To be more exact, yearly pension benefit = $1.5(A + B)(1 + 0.05N)$, where A is the monthly income averaged across all pension participants during the three years prior to pension payment, B is the average monthly income of the pension beneficiary concerned during the entire insured period (CPI-adjusted), N is the number of insured years in excess of 20 years, and “1.5” is an adjustment factor that makes the average replacement rate equal 50% with a 40-year insured period (since replacement is scheduled to fall down to 40% by 2028, this adjustment factor also drops by 0.015 each year until it reaches 1.2 in 2028).

¹⁴ The initial contribution rate was set to be 3.0% to alleviate the financial burden on the insured persons and the employers.

¹⁵ As for farmers and fisherman, government subsidizes half of their contributions.

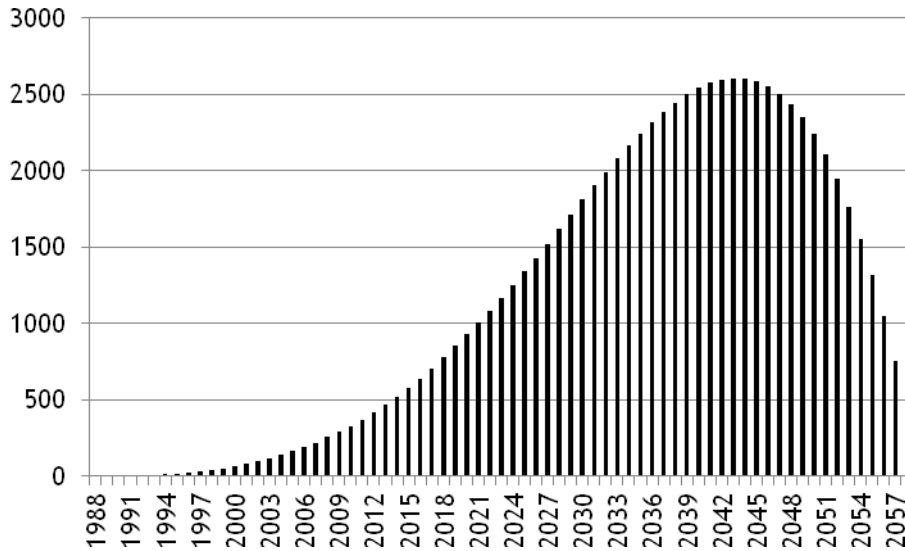
¹⁶ See Min et al. (1986).

¹⁷ The 1986 National Pension Act stipulated that the contribution rate would rise from 3 percent to 9 percent gradually over a ten year period (3 percent during 1988-1992, six percent during 1993-1997, and nine percent from 1998).

¹⁸ See Chung (2010). Cost-benefit ratio equals the present value of all pension benefits divided by the present value of all contributions.

Figure 1: Evolution of National Pension Fund Size

(in trillion Korean Won)



Source: Ministry of Health and Welfare

There were a number of endeavors to address this financial sustainability problem by lowering the replacement rate. With the revision of the National Pension Act in 1998, the replacement rate was lowered from 70 percent to 60 percent. With the revised Act, it was also decided that the age eligible to receive pension be raised gradually from 61 to 65 over a 20 year period from 2013 to 2033 (increase one year at every five-year intervals). In 2007, another revision took place and lowered the replacement rate to gradually fall from 60 percent to 40 percent over a 20 year period from 2008 to 2028 (drop 0.5%p each year). A gradual rise in the contribution rate or a drop in the replacement rate, however, means that future generation will be subsidizing the current generation. This inter-generational equity issue is another problem that characterizes Korea's National Pension Scheme.

National Pension Fund

National Pension Fund is established by the National Pension Act to serve as a reserve fund to meet the liabilities of the National Pension Scheme. Since it is a reserve fund, National Pension Scheme members do not have the beneficial ownership over NPF assets. Instead, it is the government, or the National Pension Service (hereafter "NPS") working on behalf of the government, that has the ownership over reserve fund assets. While the collection of contributions and the payments of pension benefits are carried out by NPS, the management of NPF is carried out by the NPF Management Committee. The composition of this Committee was one of the major reform subjects during the 1998 reform.

NPF assets are invested in three different sectors: the financial sector, the public sector, and the welfare sector. Public sector investment refers to deposits at government managed funds or special accounts that invests in government public sector projects. Welfare sector investment refers to various loan programs for the welfare of pension policyholders. Lastly, financial sector investment refers to the allocation of NPF assets in the capital market. Ceasing mandatory deposits for public sector investment was another key subject of the 1998 reform.

As of June 2010, the size of NPF is 295 trillion won. According to Tower Watson (2010), NPF is the fourth largest pension fund in the world, as of 2009, after the Government Pension Investment in Japan, the Government Pension Fund in Norway, and ABP of the Netherlands. **Table 1** shows the strategic asset allocation (SAA) of NPF in 2010, with the tolerance bands, and the breakdown of its actual investments across different asset classes. Domestic fixed income takes up approximately 70% of the portfolio and remains the largest asset class. Equity takes up around 22% and overseas investment take up around 10%.

Table 1: Asset Allocation of NPF

	Policy Portfolio		Actual Portfolio
	SAA	Tolerance Band	
Domestic Equity	16.6%	±5.0%	13.8%
Overseas Equity	5.1%	±1.5%	5.3%
Domestic Fixed Income	67.8%	±8.0%	71.2%
Overseas Fixed Income	4.1%	±4.1%	4.5%
Alternatives	6.4%	±2.0%	5.0%
Total (Financial Sector)	100.0%		100%

Source: National Pension Fund Management Committee and National Pension Service

Given that the fund will grow exponentially over the next 30 years and then quickly shrink to nil, NPF is destined to expand its overseas investment. Domestic capital market is not large enough to accommodate large scale swings of investment and divestment. According to the projection by MOHW, the size of NPF will be 31% of Korea's GDP at the end of 2010.¹⁹ It is expected that this fraction will grow up to 50% in 2030. In the domestic fixed income market, NPF's share has been around 18 percent for a number of years. In the domestic equity market, NPF's share is 3.57 percent as of 2009. This fraction, however, is expected to grow as NPF increases its strategic allocation into equity. One study reports that the fraction might grow to 15 percent in 2030 if NPF's allocation to domestic equity increases to 25 percent.²⁰ Former CIO of NPF once likened the situation of NPF as "a big whale trying to swim in a small pond."

III. The 1998 Reform: Detailed Chronological Account

Before the Reform

Mandatory deposit at Public Capital Management Fund (PCMF)

The most serious problem related to NPF management before the 1998 Reform was the practice of depositing its surpluses at the Public Capital Management Fund (hereafter "PCMF"). PCMF was a fund established by the Korean government in 1993, at which public sector funds were forced to deposit their surpluses.²¹ NPF was one of the ten funds listed in Article 5 of the Act subject to mandatory deposit.²² This reminds of the motivation behind the National Welfare Pension Act back in 1973. That is, using national pension as a vehicle to mobilize domestic capital.

¹⁹ GDP is estimated to be 1,062 trillion won, while NPF size is estimated to be 325 trillion won.

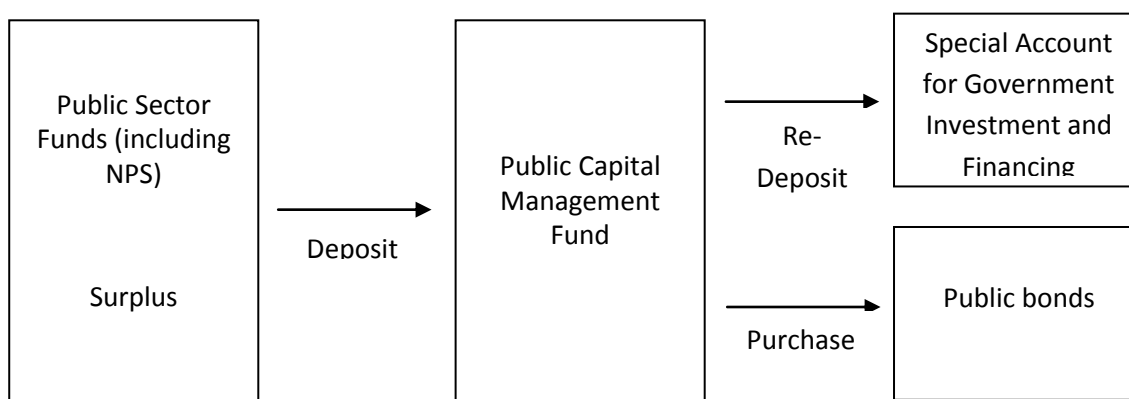
²⁰ See Korean Finance Association (2009).

²¹ PCMF had the benefit of concentrating the public sector surpluses to a single account and then allocating them to be used in more productive areas.

²² All four public pension funds were in the list.

Figure 2 shows the flow chart on how PCMF finances its funds and how they are used. Instead of issuing marketable debt, PCMF raised funds by taking deposits from various public sector funds.²³ It then re-deposited a significant portion of its funds into the Special Account for Government Investment and Financing (hereafter “Special Account”). Using this Special Account, the government made loans or investments for assisting agriculture and fishery industries, small-and medium-sized enterprises (SMEs), and expanding social overhead capital (SOCs).²⁴ The remaining portion of the funds deposited at PCMF was used to purchase government bonds.²⁵ A significant portion of the funds raised by PCMF was from NPF. In 1995, NPF contributed 78.1% of the total funds newly deposited at PCMF. PCMF was governed by a committee chaired by the Minister of Finance and Economy and mostly composed of cabinet members.²⁶

Figure 2: Public Capital Management Fund



Source: Kim (1995)

There were a number of concerns related to this mandatory deposit. First, NPF was incurring a huge loss from this deposit. In 1994, 85.9% (3.9 trillion won) of newly collected contributions was deposited at PCMF.²⁷ This was a huge jump from the previous year’s 40.5% contribution to the Special Account. But, from its PCMF account, NPF earned an interest lower than what it could have if invested elsewhere. In

²³ NPF’s deposits at PCMF were not kept in a separate account. The funds from various public sector funds were all lumped up in a single account. The deposit rate varied with maturity. As for deposits with a five-year maturity, the rate was an average of (i) medium-to long-term Treasury’s market offering yield during the past three months and (ii) public funds’ return on their financial assets. This deposit rate was adjusted only when the newly calculated rate differed from the previous one by 0.5%p or more per annum. As for deposits less than a five-year maturity, the rate was set slightly lower than the five-year deposit rate.

²⁴ According to Kim (1995), the Special Account executed 6.1 trillion won in 1994 in the form of loans, investments, and contributions. The breakdowns are agriculture and fishery industries (31.0%), SMEs (21.9%), SOCs (18.0%), Environment and Welfare (13.6%), and others (15.5%).

²⁵ According to Kim (1995), 72% of funds deposited at PCMF were re-deposited at the Special Account and the remaining 28% were used to purchase government bonds in 1995.

²⁶ The Bank of Korea Governor was the only non-cabinet member.

²⁷ In 1995, 89.8% were deposited at PCMF (4.5 trillion won). Even before the introduction of PCMF Act (mandatory deposit started in the 2nd half of 1994), NPF made deposits directly at the Special Account. But, it was a voluntary decision made by the National Pension Fund Management Committee and the amount of deposit was only a half of newly collected contributions. See Moon (1995) on this.

1994, NPF's financial sector investment earned 13.95%, while its public sector investment (deposits at PCMF) earned only 10.25%. This amounts to a yearly loss of 14 billion won. One study projected that the year of NPF's complete depletion would arrive five years earlier if NPF's allocation in the public sector staid at 100% instead of zero.²⁸ This loss *per se*, however, was not perceived as a serious problem since government can compensate for the loss later, and still be able to pay the promised pension benefits. Instead the complaint was on the introduction of PCMF Act without any prior consultation with pension participants.

Second, it was harming the fiscal soundness of Korean government. The size of NPF's yearly surplus was expected to grow exponentially. Accordingly, the amount of mandatory deposit at PCMF was also expected to grow rapidly. If government kept borrowing 80% of surplus each year, the total amount of debt outstanding against NPF would have become 143 trillion won (principal: 92 trillion won; interest: 51 trillion won) by 2006.²⁹ This is slightly more than the central government's total budget in 2006 (140 trillion won). Also, by 2000, the cumulated interest PCMF needs to pay back to NPF surpasses the new deposits made by NPF. Similar lines of argument back then gave rise to doubts that the government can pay the interests, let alone compensate for the losses. **Table 2** shows the detailed calculations.

Table 2: Projected Debt of PCMF against NPF

(unit: billion won)

Year	Contributions	Payments	Surplus	Deposits	Cumulated Deposits	PCMF Debt Outstanding	Cumulated Interests
1994	3,384	519	2,865	2,292	2,292	2,292	-
1995	4,160	755	3,405	2,724	5,016	5,245	229
1996	5,044	1,118	3,926	3,141	8,157	8,911	754
1997	5,782	1,486	4,296	3,437	11,594	13,238	1,645
1998	8,283	2,440	5,843	4,674	16,268	19,237	2,969
1999	8,851	3,872	4,979	3,983	20,251	25,143	4,892
2000	10,543	1,607	8,936	7,149	27,400	34,807	7,407
2001	12,288	1,569	10,719	8,575	35,975	46,862	10,887
2002	13,895	1,915	11,980	9,584	45,559	61,133	15,574
2003	15,666	2,328	13,338	10,670	56,230	77,916	21,687
2004	17,150	2,914	14,236	11,389	67,618	97,097	29,478
2005	18,492	3,585	14,907	11,926	79,544	118,732	39,188
2006	19,791	4,360	15,431	12,345	91,889	142,950	51,061

Notes: Contributions and payments are actual realized figures. Deposit at PCMF is assumed to be 80% of surplus. Deposit interest rate is assumed to be 10%.

Third, there was a concern that the Minister of Finance and Economy may not pursue the best interest of the NPF. The Minister chaired both committees, but the Minister had more leeway at the PCMF Committee as it had less non-government members. Naturally, the Minister had an incentive to transfer more funds to PCMF. This, however, may not be in the best interest of pension participants.

²⁸ See Chung (1991).

²⁹ Another obvious problem was that government was borrowing without any approval by the National Assembly.

National Pension Fund Management Committee

Prior to the reform, the fund management of NPS was dominated by the government in general and the Ministry of Finance and Economy (hereafter “MOFE”) in particular. First, the NPF Management Committee was chaired by the Minister of Finance and Economy. Although Article 83 of the National Pension Act stated that it is the Minister of Health and Welfare that is responsible to manage the Fund, Article 84 gives the Committee chair to the Minister of Finance and Economy.

Second, majority of the Committee members were *de facto* representing the government. The National Pension Act itself did not exclude the possibility of having a Committee independent from government. As shown in **Table 3**, the fraction of independent members can rise up to 67% by appointing ten independent members on top of five government *ex officio* members. The composition in 1998, however, was far from this. The Committee was composed of five government *ex officio* members, two representing the employers (Korea Employers Federation, Korea Federation of Small and Medium Business), two representing the employees (Federation of Korean Trade Unions, Korean Financial Industry Union), three representing other participants (National Agricultural Cooperative Federation, National Federation of Fisheries Cooperatives, and Korea Bar Association), one representing the recipients (National Pension Service), and two experts (Korea Development Institute and Korea Institute for Health and Social Affairs). Given the fact that members representing other participants, recipients, and experts are not truly independent from the government, the ratio of members under government influence was 73%.

Table 3: The Composition of National Pension Fund Management Committee

	Before 1999	Since 1999
Chairperson	Minister, Ministry of Finance and Economy	Minister, Ministry of Health and Welfare
Vice Chairperson	Minister, Ministry of Health and Welfare	
Other <i>ex officio</i> members		
Representing government	Minister, Ministry of Agriculture and Forestry Minister, Ministry of Commerce and Industry Minister, Ministry of Labor	Vice Minister, Ministry of Finance and Economy Vice Minister, Ministry of Agriculture and Forestry Vice Minister Ministry of Commerce, Industry and Energy Vice Minister, Ministry of Labor
Others		Chair & CEO, National Pension Service
Members representing participants/recipients		
Employers	1 or more	3
Employees	-	3
Other Participants	1 or more	-
Regional Participants	-	6
Recipients	1 or more	-
Experts	1 or more	2
Total	11-15	20

Events Leading Up to the Reform

PSPD Court Filings

The very first movement of reform took place outside the government. People's Solidarity for Participatory Democracy (PSPD), a civil organization founded in 1994, saw NPF's investment in the public sector as a serious problem, and in December 1994, filed a damage suit on behalf three pension participants against the Korean government.³⁰ In February 1996, the Seoul District Court that was dealing with this damage suit case filed for a constitutional review of the PCMF Act and the National Pension Act. The Constitutional Court's ruling that was made in October 1996, however, was not encouraging to PSPD. The Constitutional Court upheld the constitutionality of both Acts. The ruling, however, was not unanimous. One Justice, out of a total of nine, accepted the allegations made by PSPD, and stated that the two Acts are unconstitutional.³¹ The Seoul District Court, upon receiving the ruling made by the Constitutional Court, also dismissed the charges made in the damage suit (February 1997).

Box 1 summarizes the key arguments made by PSPD and Seoul District Court when filing the damage suit and requesting for the constitutional review. Box 2 summarizes the counter-arguments made by the Constitutional Court. The arguments made by the Court are still relevant as similar logics are often used to defend government's intension to use NPF surplus on other public policy objectives.

Box 1: Arguments made by PSPD and Seoul District Court

PSPD's accusation was based on the fact that the Minister of Health and Welfare had the fiduciary duty to maximize the return for pension participants to maintain the long-term stability of the fund (Article 83 of the National Pension Act), had to manage the fund so that the its returns are higher than the term deposit rate (Article 52 of the National Pension Act's Enforcement Decree), but the actual return on its public sector portfolio in 1993 (9.79%) was below the time deposit rate (11%), and significantly below the return on its financial sector portfolio (14.63%).

Seoul District Court's request for constitutional review was based on the grounds that the two Acts may be infringing upon the property rights (Article 23 of the Constitution), the right to pursue happiness (Constitution Preamble), and the principle that any restriction on freedom and rights should be at its minimum (Article 37 of the Constitution). Seoul District Court was particularly concerned with the fact that Article 5 of the PCMF Act was introduced in 1993 without any consultation with the NPF Management Committee nor with the pension participants and that the compulsory nature of the PCMF deposit made the Minister of Health and Welfare's fiduciary duty (Article 83 of the National Pension Act) obsolete. Seoul District Court was also concerned that giving the Chairmanship of the NPF Management Committee to the Minister of Finance and Economy (Article 84 of the National Pension Act), who is also chairing the PCMF Management Committee, may harm the interest of pension participants.

Box 2: Counter-arguments made by the Constitutional Court

First, the Constitutional Court upheld the constitutionality of the PCMF Act (Article 5).³² In response to the point that Article 5 of the PCMF Act was introduced without any prior consultation, the Constitutional Court made a number of points to defend its constitutionality. According to the Court, the introduction of the PCMF Act is a move to prevent public sector funds from solely pursuing profitability and hence becoming speculators. It is also a

³⁰ To be more exact, it was the Social Welfare Committee of PSPD that took the action. Social Welfare Committee is one of many action bodies of PSPD.

³¹ For a statute to be unconstitutional, it needs support from at least six Justices.

³² Since Article 52 of the National Pension Act's Enforcement Decree was not under the jurisdiction of the Constitutional Court, the Court made no decisions on its constitutionality.

move to give government a stable source of funding for public sector investments, which is much needed for the country, and thereby harmonizes public interest against the interest of maximizing returns. The Court also pointed out that pension surplus is not fully subject to mandatory deposit. Since the funds necessary to cover operating expenses and to meet pension obligations were not subject to the deposit, it cannot be regarded as an excessive restriction on property rights. Lastly, the Court pointed out that the Framework Act on Fund Management subjects PCMF to submit yearly fund management plans to the National Assembly.

In response to the claim that mandatory deposit harmed the profitability of NPF and made the Minister of Health and Welfare's fiduciary duty obsolete, the Constitutional Court made a number of counter arguments. First, the most important investment objective of NPF is not to maximize returns, but to maintain its long-term stability. Second, returns should not be considered in isolation, but needs to be evaluated with the level of risk that follows. Since the deposit rate at the Special Account is a rate guaranteed by the government and therefore has a lower risk, it is not necessary a bad deal for NPF. Third, in the long-run, government's use of NPF surplus on public investments can be beneficial to the pension recipients. If such investments improve the economy's growth potential and therefore strengthen the fiscal position, the government will be in a better shape to meet pension liabilities in the future.

The Constitutional Court also upheld the constitutionality of the National Pension Act (Article 84). The decision was based on grounds that the decision of the Management Committee cannot be dictated by the Minister of Finance and Economy alone, and that the non-government members representing pension participants/recipients are not completely absent in the Management Committee.

Response by MOFE

Although PSPD lost all its litigations, PSPD's voice was heard and prompted changes in the government. In response to the criticisms raised by PSPD against the mandatory deposit, in September 1997, the PCMF Management Committee revised the terms of deposit and introduced a provision that allows PCMF to compensate for the loss due to low deposit rate.³³ The Committee also set the deposit rate to be equal to the market yield of National Housing Bond (type 1).

The MOHW Bill

In January 1998, MOHW disclosed its bill to revise the National Pension Act based upon the suggestions made by the National Pension Reform Board (hereafter "NPRB"), a government committee that published its own proposals in December 1997.³⁴ MOHW's proposals related to pension fund governance and management include (i) rate on deposits at PCMF should be determined by the NPF Management Committee, (ii) the majority of the NPF Management Committee members should be non-government members³⁵, (iii) the Committee should be chaired by the Minister of Health and Welfare³⁶, and (iv) the management details PCFM deposits should be reported to the NPF Management Committee and then publicly disclosed. The MOHW's bill, however, was silent on NGO's request to remove Article 5 from the PCMF Act and giving NPF a separate account at the Special Account. It was not MOHW, but

³³ This loss-compensation provision later triggered a legal dispute between the Ministry of Finance and Economy and the National Pension Service. See details on this in later sections.

³⁴ NPRB had a wide mandate. It was asked to address the financial sustainability, pension coverage, and reserve management issues. According to World Bank (2000), it held 13 conferences and 9 meetings in 1997.

³⁵ Increase the number of committee members from 11-15 to 15-20, among which nine are government members (the Minister of Health and Welfare, five Vice Ministers, the CEO of NPS, and two experts) and eleven are non-government members (three representing employers, three representing employees, and five representing other participants).

³⁶ According to the MOHW bill, the Minister of Finance and Economy is replaced by the Vice Minister of Finance and Economy. Other Minister-level *ex officio* government members are also replaced by Vice Ministers.

MOFE that had the jurisdiction over the PCMF Act. The bill was submitted to the National Assembly in May 1998.

The New Leader and the Tripartite Talk

On December 18 1997, Korea elected Dae-jung, a long standing opposition leader, as the nation's President. Immediately after his election, the President-elect proposed the introduction of a tripartite consultation mechanism to overcome the economic crisis. Following his suggestion, on January 15 2008, The Korea Tripartite Commission was established among the workers, the employers, and the government. On February 6, the First-Phased Tripartite Commission adopted the Social Agreement for Overcoming the Economic Crisis. Among the 90 items agreed upon, two were related to NPF governance and management.³⁷ One was to remove Article 5 from the PCMF Act by the end of 1998 (item #56) and the other was to expand the participation of non-government members in the management of public pension funds (item #54).

Other Proposals

In 1998, a number of other proposals emerged regarding the NPF governance reform. Two bills were submitted by members of the National Assembly. One bill proposed that the Prime Minister should chair the NPF Management Committee. Another bill proposed that PCMF issue debt securities instead of taking deposits. PSPD, which initiated the debate in 1994, also came up with its own proposal at a conference it organized in April 2008.³⁸ Regarding NPF's public sector investment, PSPD proposed to (i) abolish Article 5 of the PCMF Act, (ii) require mutual agreement between MOFE and the NPF Management Committee when setting the level of government borrowing from NPF, (iii) require PCMF to issue debt securities, instead of taking deposits, when borrowing from NPF, (iv) establish a separate account exclusive for NPF at the Special Account for Government Investment and Financing, (v) revise the Framework Act on Fund Management and require NPF to get approval from the National Assembly on its public sector investments, (vi) require NPF to establish and disclose a five-year plan on its public sector investments.

Regarding the NPF Management Committee, PSPD proposed to (i) increase the number of Committee members that represent public interest,³⁹ (ii) appoint resident members working full-time among the non-government members who represent pension participants, (iii) require the Committee meetings to be held at least once every quarter, (iv) allow members to summon the Committee meeting with a request made by at least one third of the members, (v) publicly disclose the Committee minutes, and (vi) ban Committee meetings that are held only in documents. Regarding NPF's portfolio management, PSPD proposed to (i) disclose the details of financial and welfare sector investments, (ii) strengthen *ex post* performance evaluation of financial sector investments,⁴⁰ and (iii) positively consider the option of establishing a separate investment office.⁴¹

³⁷ The First-Phased Tripartite Commission was launched in January 1998 and lasted until May 1998.

³⁸ See PSPD (2008).

³⁹ In its petition for National Pension Act revision, submitted to the National Assembly in May 1998, PSPD proposed a 19 member NPF Committee composed of five *ex officio* government members, two recommended by unions, two recommended by employer organizations, three representing regional pension participants, three experts recommended by civil organizations, and four experts representing the public interest.

⁴⁰ In its May 1998 petition for National Pension Act revision, PSPD proposed to establish a NPF Evaluation Committee as a subcommittee of the NPF Management Committee.

⁴¹ The last point was also suggested by the National Pension Reform Board.

At this April conference PSPD organized, all discussants, one representing the employers (Korea Employers Federation), two representing the employees (Federation of Korean Trade Unions, Korean Confederation of Trade Unions), and one politician from the opposition party (Grand National Party), fully endorsed the proposal put forth by PSPD.⁴²

In May, PSPD filed a petition to the National Assembly to revise five Acts (the National Pension Act, the PCMF Act, the Framework Act on Fund Management, the Special Account for Government Investment and Financing Act, and the Budget and Accounts Act) according to the proposal it made in April.

IBRD Makes its Own Input

Despite the agreement made at the tripartite talk in February, MOFE did not take action to revise the PCMF Act until November. In August, PSPD with two trade unions (Federation of Korean Trade Unions, Korean Confederation of Trade Unions) even issued a public statement that the National Pension Act revision bills should not be reviewed at the National Assembly unless Article 5 of the PCMF Act is removed. According to this statement, MOFE was concerned of not being able to use NPF surpluses for public sector investments. At the Second-Phase Tripartite Commission meetings, MOFE put forth an alternative proposal. Instead of abolishing Article 5 of the PCMF Act, it proposed to pay market interests on PCMF deposits and, by 2001, replace all PCMF deposits with government bonds.⁴³ This still meant that the decision on the size of NPF's public sector investment will not be a voluntary one made by the NPF Management Committee, but a decision dictated by the PCMF Act.

MOFE, however, gave in when it finalized its SAL II negotiation with World Bank in September. Phasing out mandatory deposit at PCMF was one of the conditions for the second tranche release of World Bank's 2 billion dollar Structural Adjustment Loan (SAL II).⁴⁴ Specifically, MOFE agreed to phase out mandatory deposit by the end of 2001. That is, taking no more than 65% of NPF surplus flow in 1999, 40% in 2000, and 20% in 2001. Also, MOFE agreed to repay outstanding loans from NPF in full at maturity without rollovers. Pursuant to this agreement, MOFE submitted a bill to revise the PCMF Act in November. The bill proposed to remove NPF from the list of public sector funds that must deposits at PCMF under Article 5. It also proposed to add a supplementary provision to the PCMF Act so that NPF can take deposits from NPF during the next two years (65% of surplus in 1999 and 40% in 2000) despite the revision of Article 5.⁴⁵

World Bank made a number of suggestions regarding pension fund governance besides the phase-out of the mandatory deposit at PCMF. One section of the SAL II Policy Mix was on "Labor Market and

⁴² Such coalition of all stakeholders, except for MOFE, is not something one would see for pension scheme reform measures where replacement rates are lowered. Labor unions and NOGs strongly resisted the 2007 reform that lowered replacement to fall from 60 percent to 40 percent over the next 20 years.

⁴³ See Kim (1998) on details. The Second-Phase Tripartite Commission was launched in June 1998 and lasted until August 1999.

⁴⁴ According to Bateman (2007), SAL II was approved on October 22, 1998. The first US\$1 billion was released immediately on October 23 1998 and the second (released on May 11, 1999) was conditional upon satisfactory implementation of recommended policy actions. Annex to the SAL II Policy Matrix lists the conditions for second tranche release. Among the twelve conditions, the very last, but not least, was the "implementation of the phased reduction of forced government appropriations from the National Pension Fund agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act." SAL I also recommended a phase-out of mandatory deposit at PCMF, but the Bank recommended a 'gradual' phase-out without any specific timetable.

⁴⁵ The bill was an improvement over the agreement made with World Bank as no deposits can be made in 2001.

Social Safety Nets” and under this section there is a list of policy recommendations related to pension fund governance and management. **Table 4** summarizes the recommendations.⁴⁶

⁴⁶ See World Bank (1999) and (2000a).

Table 4: World Bank Recommendations on Pension Fund Governance and Management

SAL I (March 26, 1998)		SAL II (October 22, 1998)	
Policy Measures	Monitoring Indicators	First Tranche	Second Tranche
Agreement to gradually phase out government borrowing from pension fund reserves in the form of direct credits and to gradually phase in government borrowing from pension fund reserves in the form of sale of marketable government bonds	In consultation with the Bank, announce by June 30, 1998, an implementation timetable, which includes appropriate revision of the Public Fund Management Act.	Adopt and announce a timetable for implementation of the reduction in forced government appropriation of the flow of NPF surpluses (per SAL I agreement) as follows: 65% of the surplus flow in 1999, 40% in 2000, 20% in 2001, and 0% in 2002. Announce that the stock of outstanding loans to government from NPF will be repaid in full at maturity without rollovers.	Implement the phased reduction of forced government appropriations from NPF agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act.
Strengthen the tri-partite asset management committee for the national pension reserve fund, responsible for strategic decisions of asset allocation and determination of benchmarks for risk and return	Necessary change in law enacted before July 1, 1998.	In consultation with the Bank, announce specific guidelines for governance of NPF reserves, including: (a) the task of the asset management committee; (b) investment rules and rating procedures; (c) benchmarking and reporting mechanism; and (d) index-based criteria for selecting external fund managers.	
Strengthen the professional investment unit in the National Pensions Corporation in charge of daily investment decisions according to the portfolio envelope and benchmarks from the committee	Training of staff of investment unit in international financial institutions.		Implement plan to strengthen the professional investment unit in the National Pension Corporation (per SAL I agreement), including: (a) achievement of a high standard of staff qualifications and supporting technology; and (b) adequate resources to monitor external fund managers.

<p>Outsource a rising part of the investment decisions to private asset management firms selected in a transparent and competitive manner. The investment unit is in charge of performance monitoring and supervision, and reports investment performance on monthly basis.</p>	<p>Publication of a quarterly performance report by 1999</p>		<p>Announce a schedule acceptable to the Bank for contracting out asset management and implement plan to increase gradually and substantially the share of NPS assets outsourced to external fund managers (per SAL I agreement), including: (a) increased unit amount outsourced per external fund manager in order to attract interest of reputable firms; and (b) adoption of revised criteria for selecting and recontracting external fund managers to reflect diversification of investment risks.</p>
			<p>Commitment to: (a) phase out per agreed timetable all lending from NPF to program participants using their contribution as collateral; and (b) refrain from providing financial assistance from NPF to restructuring of financially distressed corporations.</p>
		<p>Commitment to establish an Office or function of the Actuary in the Office of the Prime Minister responsible for annual projections of the long-term actuarial status of all public pension schemes based on consistent macroeconomic and demographic assumptions.</p>	<p>Establish the Office/function of the Actuary. Allocate adequate FY99 budget to prepare and publish the first annual status report for FY98.</p>

Source: World Bank (1999) and World Bank (2000a)

The National Pension Act Passes the National Assembly

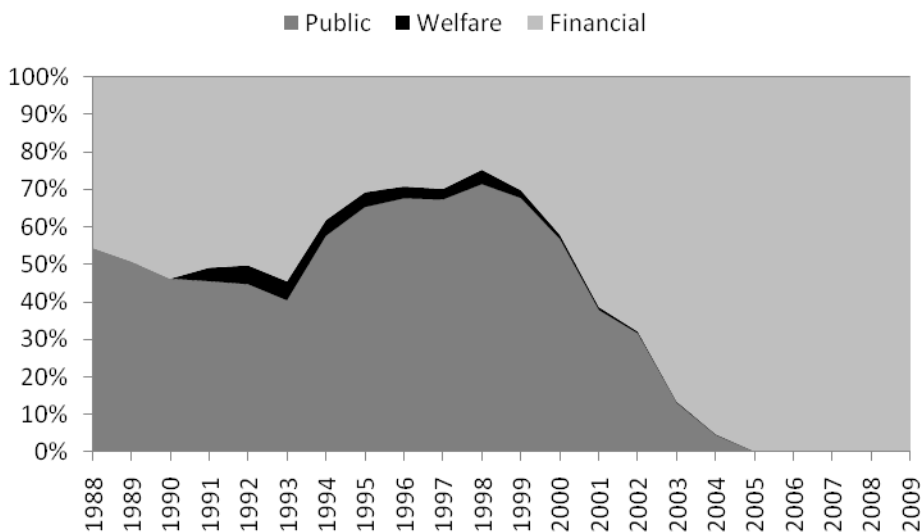
The National Pension Act revision bill passed the National Assembly (December 17, 1998) and was promulgated in December 31, 1998. Also, the PCMF Act revision bill MOFE submitted passed the National Assembly (December 29, 1998) and was promulgated in January 29, 1999.

After the Reform

Abolishment of forced deposit at Public Capital Management Fund

With the passage of the bill revising the PCMF Act, the NPF’s mandatory deposit at PCMF had to be phased out (65% of surplus flow in 1999 and 40% in 2000). Also, the deposit rate had to be determined by an agreement between the NPF Management Committee and the PCMF Operating Committee and be set at a rate above the 5-year government bond yield (Article 83-3). With the revision of the National Pension Act Enforcement Degree, the deposit rate had to be either the government bond yield or the National Housing Bond yield (type 1), whichever is higher. In the **Figure 3** and **Table 5** shows the fraction of public sector investments by NPF. Allocation to public sector peaked in 1998 at 71.5%, and then subsequently dropped to zero in 2005.

Figure 3: Fraction of Public Sector Investment by NPF



Source:

National

Pension

Serve

Table 5: Fraction of Public Sector Investments by NPF

Year	Fund (billion KRW)	Public	Welfare	Financial
1988	528	0.546	0	0.454
1989	1,233	0.509	0	0.491
1990	2,199	0.463	0	0.537
1991	3,328	0.456	0.036	0.508
1992	4,750	0.448	0.051	0.502
1993	7,612	0.405	0.051	0.544
1994	11,356	0.577	0.043	0.381
1995	15,955	0.654	0.039	0.306
1996	21,671	0.677	0.032	0.291
1997	28,282	0.674	0.028	0.297
1998	37,465	0.715	0.038	0.246
1999	46,992	0.678	0.021	0.301
2000	61,329	0.568	0.012	0.420
2001	77,827	0.379	0.008	0.613
2002	95,925	0.316	0.005	0.678
2003	116,504	0.131	0.004	0.865
2004	140,791	0.045	0.003	0.952
2005	163,653	0	0.002	0.998
2006	189,308	0	0.001	0.999
2007	219,214	0	0.001	0.999
2008	235,186	0	0.001	0.999
2009	277,406	0	0.001	0.999

Source: National Pension Service

This does not mean that government does not borrow at all from NPF. NPF actively participates in competitive auctions to purchase government bonds, and this is now considered as a financial sector investment. For example, in 2000, the fraction of surplus flow deposited at PCMF was 37.2%, which is below the 40% cap. But, if one adds NPF's investment in government bonds, the fraction of NPF's total investment reaches 54.1%.

One interesting episode related to mandatory deposit at PCMF is the legal dispute between MOFE and NPS that took place in 2004. Box 3 summarizes the story.

Box 3: Legal Dispute between MOFE and NPS

The dispute dates back in 1997 when the PCMF Management Committee revised the terms of deposit and introduced a provision that allows PCMF to compensate for the loss (at the end of first quarter in the following year) due to low deposit rate. During the 2004 inspection of state affairs, Sang-jung Shim, a member of the National Assembly, disclosed that MOFE needs to pay back 2.6 trillion won to NPS as a compensation for the loss incurred due to mandatory deposit at PCMF. She also disclosed that MOFE mistakenly paid interest based on the National Housing Bond yield even when the government bond yield was higher during September-October 1999 and March – December 2000. With the revision of the National Pension Act Enforcement Degree in December 1998, the deposit rate had to be either the government bond yield or the National Housing Bond yield (type 1), whichever is higher. According to her calculation, MOFE had to pay back 48.2 billion won to NPS.

Such claims were supported by MOHW, non-government civilian member of the NPF Management Committee, and NPS. Despite such pressure, MOFE declined to compensate for the 2.6 trillion won loss based on the logic that the terms of deposit introduced in 1997 was not a mandatory provision, but a voluntary one, and therefore does not constitute any legal obligation. In July 2005, NPS took the second case (loss of 48.2 billion won) to the court, but claimed only a small fraction of the loss (3.5 billion won). Seoul District Court, however,

dismissed the case since the three-year period, within which the plaintiff's had the right to claim damage, already expired.

National Pension Fund Management Committee

The Committee was restructured in a number of ways by the 1998 National Pension Act revision. First, the revised Act reduced the influence of MOFE by giving the Committee chairmanship to MOHW. MOFE now participates in the Committee meetings through its Vice Minister, who acts as one of many regular members. Second, the revised Act strengthened the monitoring role of non-government members by giving them more seats in the Committee. Out of a total of 20 members, 12 represent pension participants: three from employers, another three from employees, and the remaining six from regional participants. **Table 3** shows how the composition changed with the 1998 revision. Third, the revised Act created the National Pension Fund Evaluation Committee as a sub-committee to review and evaluate the agenda items to be determined by the NPF Management Committee. The Evaluation Committee is a 20 member committee chaired by the Vice Minister of Health and Welfare. **Table 6** shows the composition of this Evaluation Committee.

Table 6: The Composition of National Pension Fund Evaluation Committee

	Affiliation
Chairperson	Vice Minister of Health and Welfare
Vice Chairperson	Rotate among the members
Other <i>ex officio</i> members	
Representing government	Director-General, Ministry of Health and Welfare Director-General, Ministry of Finance and Economy Director-General, Ministry of Agriculture and Forestry Director-General, Ministry of Commerce, Industry and Energy Director-General, Ministry of Labor
Members representing participants/recipients	
Employers	3
Employees	3
Regional Participants	6
Experts	2
Total	20

Fourth, the revised Act is explicit about the responsibilities of the NPF Management Committee. It clearly states in article 84 that the Committee has the exclusive power to make NPF's investment policy decisions. Fifth, the revised Act significantly enhanced the transparency of the Committee meetings by making it mandatory to disclose the minutes. By visiting the MOHW website, anyone can freely download the documents discussed and the minutes of past meetings. Sixth, the revised Act also made procedural improvements in Committee meetings. For example, meetings could not be attended by substitutes, meetings in writing were not allowed, and it became mandatory to hold at least one meeting every quarter.

Establishment of Fund Management Center and Appointment of CIO

Another major change that took place immediately after the 1998 National Pension Act revision was to establish the Fund Management Center within the National Pension Service (NPS) and appoint its head who will serve as NPF's Chief Investment Officer (CIO). Although the Act itself was silent on the Fund Management Center (hereafter "FMC"), it mandated the Minister of Health and Welfare to appoint Executive Fund Director (EFD), who will serve as the CIO. According to the Act, EFD is one of the seven

National Pension Service (NPS) executive directors appointed by the Minister of Health and Welfare. But, unlike other executive directors, special provisions exist in the Act that stipulates the qualifications and the process of its candidate nomination. EFD candidates must have in-depth knowledge and experience in the field of investment management, and its nomination must be carried out by a committee chaired by the NPS CEO. The committee is required to run an ad for the position in a major daily newspaper and, separate from this, was allowed to hire a recruiting agency to identify qualified candidates.

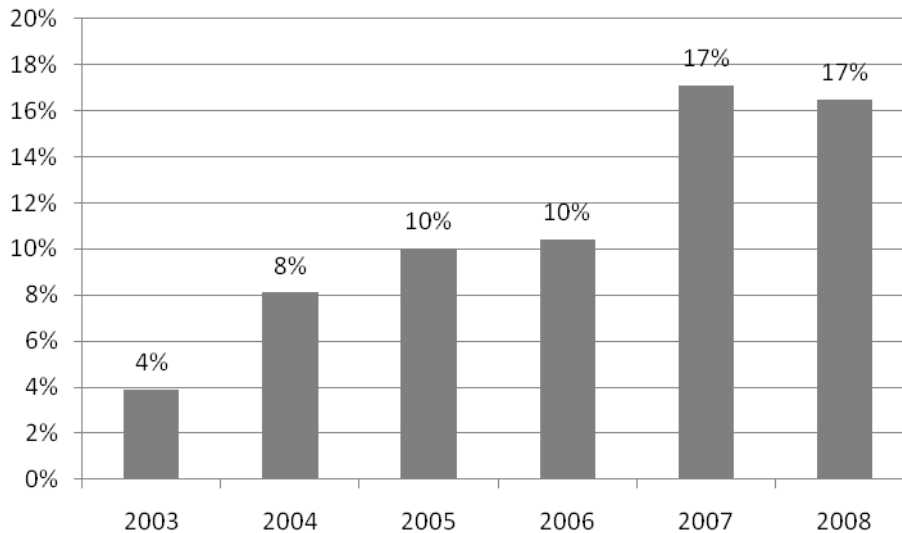
After several months of preparation, NPS officially launched the Fund Management Center in November 1999. The Minister of Health and Welfare also appointed the first CIO, who will serve the Fund Management Center as its head and at the same time serve as the Executive Fund Director of NPS. The Fund Management Center started its business with 39 employees, among which 22 were professional investment managers under a three-year contract. National Pension Research Institute (hereafter “NPRI”), an in-house research institute of NPS, was assigned with the task of evaluation the Center’s investment performance. The task of auditing the Center’s investment activities was assigned to the NPS Audit Department.

Hiring External Managers

Since 2000, the Fund Management Center steadily increased the proportion of external management. **Figure 4** shows the size of external management as a fraction of NPF’s total financial sector investment. By the end of 2007, it reached 17%. This fraction varies across different asset classes, however. For example, in case of overseas equity, alternative assets, and domestic equity, the fractions are 100%, 68.4% and 53.9% respectively as of 2007. In case of domestic and overseas fixed incomes, the fractions are 5.1% and 13.2% respectively as of 2007. The number of external managers also increases substantially. By the end of 2007, there were 99 external managers hired by NPS. In 2007, NPF Management Committee started to set external management target weights. In case of 2007, the overall target weight for financial sector investment was 15% with a +/- 4.8 tolerance band. The Committee also sets target weights on external management for individual asset classes.⁴⁷

⁴⁷ In 2007, the target weights were 53%(domestic equity), 4.5%(domestic fixed income), 100%(overseas equity), 12.75%(overseas fixed income), and 68.5%(alternative assets).

Figure 4: Fraction of External Management by NPF

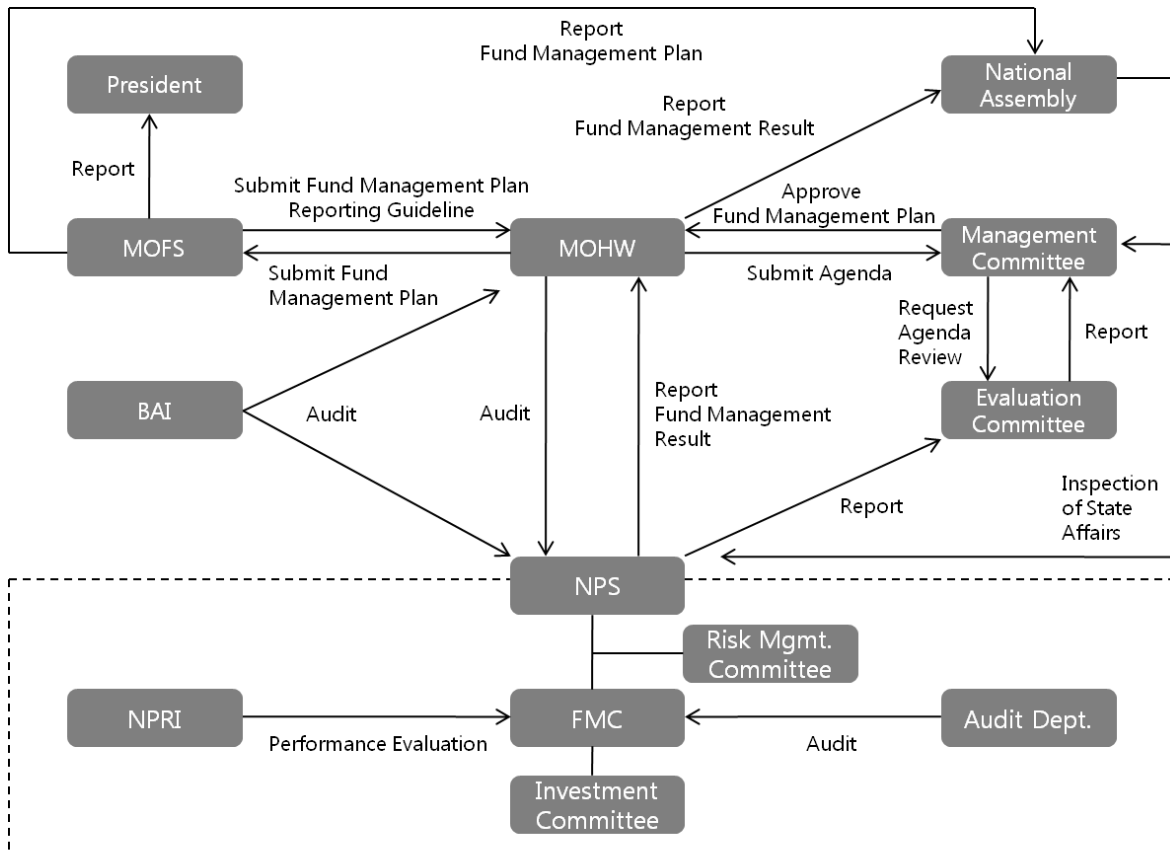


Source: NPF Management Committee (2008)

Current NPF Governance Structure

Figure 5 shows the internal and the external governance structures of NPF. The day-to-day management of NPF is conducted by the Fund Management Center (FMC) within NPS under the leadership of its CIO. Internal audit is conducted by the audit department and *ex post* performance evaluation is carried out every six months by the National Pension Research Institute, the in-house research institute of NPS, jointly with an outside consultant hired by the Ministry of Health and Welfare. Investment Policy of NPF, however, is determined by the NPF Management Committee, which is chaired by the Minister of Health and Welfare. MOHW serves as the Management Committee's secretariat. The NPF Evaluation Committee, a sub-committee of the NPF Management Committee, reviews the agenda before MOHW submits it to the Management Committee. Investment and risk management committees exist, but as committees inside NPS and not directly reporting to the NPF Management Committee. Ministry of Finance and Strategy, a new name of MOFE since 2008, give out reporting guidelines to public sector funds on their fund management plans. MOHW submits the plan for NPF once determined by the NPF Management Committee. This plan is reported to the President and also to the National Assembly. External audit is conducted by three entities: the National Assembly, the Bureau of Audit and Inspection, and MOHW.

Figure 5: Current Governance Structure of National Pension Fund



MOHW: Ministry of Health and Welfare
 MOFS: Ministry of Finance and Strategy
 BAI: Bureau of Audit and Inspection
 NPS: National Pension Service
 FMC: Fund Management Center
 NPRI: National Pension Fund Research Institute

Source: National Pension Service with authors' modification

IV. The 1998 Reform: Analyses

The Direct Stakeholders

The direct stakeholders of the 1998 Reform include the two government ministries (MOHW and MOFE) and the pension participants (mainly, the employers and the employees). MOHW and pension participants obviously benefited from the reform. The Minister of Health and Welfare overtook the chairman position in the NPF Management Committee from the Minister of Finance and Economy. As contributors and beneficiaries of the National Pension Scheme, the employers and the employees were both in favor of the reform. They were concerned that the mismanagement of NPF would result in an increase in future contributions or a drop in future pension benefits. Pension governance reform was one of the very few areas where the two had their interests aligned.

MOFE, on the other hand, was against the reform for fear that the ministry will no longer be able to use NPF surpluses for public sector investments. Historically, MOFE had a view that the reserve fund of National Pension Scheme, like any other public sector funds, can be utilized for other policy purposes. This view dates back in 1973 when President Park Chung-hee introduced the National Welfare Pension Act.

Despite the absence of a social pressure to introduce social insurance, the idea of introducing a national pension scheme caught the interest of President Park because it was understood as a vehicle to mobilize domestic capital much needed to financially support his industrial policy targeting heavy-equipment and chemical industries.

Preparation and Leadership by an NGO

The 1998 reform did not come from a vacuum. People's Solidarity for Participatory Democracy (PSPD), a civil organization established in 1994, initiated the debate early on in December 1994 by filing a damage suit and requesting a constitutional review of the two related acts (the National Pension Act and the PCMF Act).⁴⁸ Back then, litigation was rarely used as a civil campaign tool in Korea. PSPD was one of the first pioneers and its very first experiment was the filing of NFP damage suit. In retrospect, this filing was an effective way to attract attention from the media, the government, and the public.⁴⁹

PSPD also took the leadership role of organizing the interests of pension participants (employees and employers) and submitting its own proposal to the National Assembly in May 1998.⁵⁰ Many of its proposals were later accepted in the revised National Pension Act that passed the National Assembly in December 1998. MOHW was also in preparation. In December 1997, the National Pension Reform Board (NPRB) published proposals to address the financial sustainability, pension coverage, and reserve management issues. MOHW's initial bill to revise the National Pension Act was based on NPRB's proposals.

Crisis and the Window of Opportunity

The balance of power between MOFE and the rest (including MOHW, pension participants, and PSPD), tilted in favor of the later with the financial crisis of 1997. First, the crisis helped the long-standing opposition leader, Kim Dae-jung, to be elected as President in December 1997, and this newly elected President was in favor of the reform. The democratization of NPF Management Committee and the investment of NPF assets in the capital market were closely in line with the nation's new guiding principles – *democratization* and *market-oriented reform* – he personally set on the evening of his election victory.

The crisis also prompted the President to introduce a tripartite consultation mechanism among the workers, the employers, and the government. At the Tripartite Commission meetings in January 1998, MOFE was a minority and it had no political supporters. Even the Grand National Party, which became an opposition party with the inauguration of President Kim Dae-jung was in favor of the reform. The Social Agreement for Overcoming the Economic Crisis, adopted in February 6 1998 by the Tripartite Commission, explicitly states to remove Article 5 from the PCMF Act by the end of 1999 (item #56) and to expand the participation of non-government members in the management of public pension funds (item #54).

Outside Pressure

Despite the agreement made at the tripartite talk in February, MOFE was reluctant to take any immediate action. The ministry even put forth an alternative proposal during the second-phase Tripartite

⁴⁸ Mr. Park Won Soon, Secretary General of PSPD at the time of litigation, and Mr. Lee Chan Jin represented the plaintiffs.

⁴⁹ KDI, a think tank of MOFE also raised concerns over the practice of mandatory PCMF deposit. See Moon (1995).

⁵⁰ Professor Kim Yeon Myung of Sangji University was the key person that led the debate. At PSPD, Professor Kim served as Vice Chairman of the Social Welfare Committee.

Commission meetings. But, in September 1998, MOFE had no choice but to give in. World Bank conditioned the second tranche release of its 2 billion dollar Structural Adjustment Loan (SAL II) on the gradual phase out of PCMF mandatory deposit.

Besides the condition to terminate mandatory deposit at PCMF, the Bank made a number of other recommendations, as shown in **Table 4**. They include (i) strengthening the NPF Management Committee, (ii) strengthening the professional investment unit in NPS, (iii) hiring external managers, and (iv) establishing an office or a function in the Office of the Prime Minister to project long-term actuarial status of all public pension schemes. In subsequent years, the first three of these recommendations were carried out by the Korean government although they are not the conditions for SAL II second tranche release. The office or the function of government actuary was not created in the Office of the Prime Minister. Instead, MOHW have been carrying out five-yearly actuarial projections (the most recent projection was made in 2008).

In later years, the Bank also provided technical assistance. First, the ASEM Grant for Social Protection of the Elderly (US\$ 870,000) was approved to provide technical assistance for the implementation of SAL II. The grants were used to support the Pension Reform Task Force, the establishment of which was required under SAL II, and to improve the fund management capacity of NPS.⁵¹ Second, the Bank provided assistance to Korea via an analytical policy advice paper (World Bank 2000b). While the paper's focus was mainly on reforming the pension scheme, it did have a section on improving the management of NPF reserves.

Institutionalization of the Reform

The 1998 Reform outcomes institutionalized, meaning they were not reversed in later years. It is true that there were attempts from other government ministries, especially from MOFE, to use NPF reserves for other policy purposes. But, most of the attempts failed. Overall, the NPF Management Committee exercised its exclusive power over the management of NPF for the sole purpose of maximizing the interest of pension participants.

This is partly due to the fact that the head of PSPD became one of six members that represent regional participants in the NPF Management Committee. PSPD was also present in the Evaluation Committee.⁵² As representatives of a civil organization that initiated the reform, they worked vigilantly with other non-government members to block any attempt to divert NPF reserves for other policy or politically-motivated purposes. **Table 7** lists the types of intervention attempts made by other ministries.

⁵¹ Under SAL II, the Bank recommended an establishment of Pension Reform Task Force by October 1998 and a completion of a White Paper no later than November 1999. The White paper should be on an integrated pension reform package combining public/private and mandatory/voluntary pensions pillars designed to attain: (a) a reasonable replacement rate target for the average worker; (b) reasonable protection from poverty for the aged; and (c) long-term financial sustainability.

⁵² Professor Kim Yeon Myung, who was instrumental in the 1998 Reform, became a member of the NPF Evaluation Committee, representing PSPD. From 2004, Mr. Lee Chan-Jin, the lawyer that filed the NPF damage suit in 1994, joined as the member of the NPF Evaluation Committee.

Table 7: List of Attempts to Use NPF for Other Policy Purposes

Types of Intervention	Detailed Examples
Invest in domestic stock market	At an interview with MBC TV, the First Vice Minister of Finance and Economy said that he will actively guide the National Pension Fund so that it frontloads its planned investments in the domestic stock market (January, 2008).
Invest in Social Overhead Capital (SOC)	Ministry of Finance and Economy finalized the plan to expand its investments in SOC (Korean New Deal) to boost up the economy. It was also announced that the bulk of SOC projects will be financed by public sector funds, including NPF (November 2004)
Contribute to FX market stabilization	Ministry of Finance and Strategy expresses its hope that NPF can contribute to FX market stabilization in times of crisis (June 2010)
Allocate assets to a sovereign wealth fund	Ministry of Finance and Economy proposes a bill establishing the Korea Investment Corporation (KIC). Officials say that KIC will manage part of NPF's overseas investments (July 2004).
Acquire shares of privatized former SOE	In a report to the President, the Ministry of Information and Communications discusses an option to make NPF acquire the shares of KT as a way to influence KT continue with its public service functions (November 2005).
Participate in government housing projects	Prime Minister expresses his view that NPF reserves could be used to finance government housing projects (July 2007).
Participate in a half-priced golf club project	Ministry of Finance and Economy announced that NPF decided to participate in the half-priced gold club project. The Ministry claimed that this project will reduce overseas golf trips and thereby the nation's travel account deficit (November 2007).
Serve as white knight	At an interview with MBC Ratio, a senior incumbent party politician who served as the Minister of Health and Welfare said that NPF should act as a white knight for Korean public corporations against hostile takeover attempts made by foreigners (June 2006)

Source: Various news paper articles

Interaction with Other Reform Areas

PSPD's experiment with litigation as a civil campaign tool in 1994 was instrumental in giving birth to PSPD's shareholder activism. In June 1997, The Economic Democratization Committee, a sister action body of Social Welfare Committee within PSPD, filed a derivative suit against the directors of Korea First Bank.⁵³ This was the first derivative suit ever filed in Korea since the introduction of Commercial Code in 1962. The Economic Democratization Committee's victory over this litigation in July 1998 (Seoul District Court) triggered a series of derivative suit filings, including the those against the directors of Samsung Electronics (October 1998), LG Chemical (January 2003), and Hyundai Motors (May 2008).⁵⁴

⁵³ The litigation was led by Mr. Joo Young Kim. The Economic Democratization Committee was led by Professor Hasung Jang of Korea University.

⁵⁴ The Samsung Electronics case closed in October 2005 when the Supreme Court ordered the directors to pay 19 billion won to the company. In 2001, the Seoul District Court ordered 98 billion won. The LG Chemical case closed in August 2006 when Seoul District Court ordered the directors to pay 40 billion won to the company. The Hyundai Motors case closed in February 2010 when the Seoul District Court ordered the directors to pay 70 billion won to the company.

In later years, the direction of influence reversed. That is, corporate governance reform spilled over to pension governance reform. Members of the Participatory Economy Committee (PEC) – the new name of Economic Democratization Committee of PSPD since September 2001 – saw NPF as an institutional investor that can contribute to strengthening corporate governance in Korea. At a seminal conference organized by PSPD in October 2001, PEC urged NPF Management Committee to be more active in its proxy voting.⁵⁵ This and other ensuing efforts by PEC led NPF Management Committee to adopt its first proxy voting guideline in December 2005.⁵⁶ Corporate governance specialists, including those at PEC, also actively participated in the debate over NPF governance reform that took place since 2003.

V. Remaining Issues in NPF Governance

Lack of Expertise and Distorted Leadership

Democratization vs. Expertise

The 1998 Reform achieved the democratization of NPF Management Committee. Out of a total of 20 members, 12 were non-government civilian members representing pension participants: three representing the employers, another three representing the employees, and the remaining six representing regional participants. The six members representing regional participants were further broke down into three groups: two representing the agriculture and the fishery sectors; two representing self-employed workers, other than those in the agriculture and the fishery businesses; and the last two representing consumers and civil society. To implement this, MOHW designated twelve organizations that represent the sectors listed above. Each designated organizations then nominated their heads to serve as Committee members.⁵⁷

Democratization of the Committee, however, did not ensure the necessary expertise needed from its members to guide the pension fund. The heads nominated by the twelve organizations, hardly had any knowledge or experience in investment management. Neither did the five *ex officio* government members (the Minister of Health and Welfare and the five Vice Ministers) or the CEO of NPS had the needed expertise in investment management. The remaining two seats planned to be filled by experts, however were filled by the heads of government think tanks: Korea Development Institute and Korea Institute for Health and Social Affairs. Neither did they have the expertise in investment management. The situation was no better at the NPF Evaluation Committee, which was set up as a sub-committee to assist the NPF Management Committee. None of the members had the expertise to set the investment policy of NPF.⁵⁸ The National Pension Act does have a provision on the eligibility requirements of NPF Evaluation Committee members. But, the requirements are not strict enough to ensure the presence of investment

⁵⁵ The author of this paper was the key presenter at this conference.

⁵⁶ The author of this paper and another member of PEC (Mr. Kim Sunwoong) actively participated in drafting the guideline.

⁵⁷ The twelve organizations designated in 1999 to nominate a member include: Korea Employers Federation, Federation of Korean Industries, Korea Federation of Small and Medium Business, Federation of Korean Trade Unions, Korean Confederation of Trade Unions, Korea Financial Industry Union, National Agricultural Cooperative Federation, National Federation of Fisheries Cooperatives, Korean Institute of Certified Public Accountants, Korea Restaurant Association, Korea National Council of Consumer Organizations, People's Solidarity for Participatory Democracy,

⁵⁸ Even at the time of this writing there is only one member in the NPF Evaluation Committee that can be regarded as an investment management expert.

management experts.⁵⁹ The head of Fund Management Center (FMC) was not a member in either Committee.

In the absence of expertise, NPF Management Committee has been relying heavily on non-standing advisory committees composed of investment specialists, when establishing its long-term investment policies. Such examples include the reports prepared by the NPF Mid-to Long-term Investment Policy Committee (2002) and the NPF Mid-to Long-term Master Plan Committee (2004).⁶⁰ It was in 2006 when NPF Management Committee was able to have its first Investment Policy Statement (IPS). This document, which is not disclosed to the public, includes strategic asset allocation (SAA) decision of NPF over a five-year period.⁶¹ In 2010, the NPF Management Committee established another non-standing committee to set the investment objective of NPF based on asset-liability analysis.

Another approach adopted by the NPF Management Committee was to establish standing advisory committees. At the time of this writing, NPF Management Committee has two: the Proxy Voting Advisory Committee and the Performance Evaluation and Compensation Advisory Committee. Experts in relevant fields are appointed by the Minister of Health and Welfare for a two-year term. Both committees were established in 2006.

Lack of Leadership and Distortion

100% of the NPF Management Committee members are non-resident members. NPF Management Committee activities take up only a small part of their total work hours. This lack of time commitment and the lack of investment management expertise by the Committee members led to another serious problem. The NPF Management Committee is not in a position to exercise leadership in setting NPF investment policies.

This leadership vacuum is partly filled by MOHW, which serves as the secretariat of NPF Management Committee. In particular, information and power are being concentrated into the Division of National Pension Finance in MOHW. Problems are spot, agendas are set, and solutions are provided by this Division with the help of outside non-standing advisory committees. People jokingly say that the Division Chief of National Pension Finance is *de facto* in charge of NPF investment management. In recent years, this power is being shared with the CEO of NPS. This is because, unlike in the past, financial experts – a former commercial bank CEO and a former head of Financial Service Commission – are appointed to the position. As a member of the NPF Management Committee and the Chair of the NPF Risk Management Committee, the recent CEOs of NPS have significantly increased their involvements in NPF investment management.

Such development, however, is unhealthy as it jeopardizes one of the key achievements of the 1998 Reform – democratization of NPF management. If major decisions are being *de facto* made outside the NPF Management Committee, the 1998 Reform merely democratized a committee that plays no role.

⁵⁹ NFP Evaluation Committee members had to meet at least one of the following three eligibility requirements: (i) a lawyer or a CPA, (ii) at least three years of experience as a professor in the field of social welfare, economics, or management, (iii) at least three years of working experience in a research institute or in a government organization in the field of social welfare, economics, or management.

⁶⁰ These *ad hoc* advisory committees were dissolved immediately after they fulfilled their original mandates.

⁶¹ Since 2006, NPF Management Committee has been reviewing its IPS every year.

Governance Reform Bills

Early discussions to reform the governance structure of NPF management date back in 2000 when National Pension Research Institute (NPRI) published a report on the governance structure of NPF.⁶² The October 2001 seminar organized by PSPD also discussed the need to reform the governance structure of NPF. The report published by the NPF Mid-to Long-term Investment Policy Committee in 2002 also stresses the importance of NPF governance reform. Against this backdrop, a number of attempts were made to change the governance structure of NPF management since 2003.⁶³ **Table 8** summarizes the similarities and the differences across different government bills to revise the National Pension Act.

Table 8: Comparison of NPF Governance Structure across Different Bills

	Current Structure (1999 -)	The 2003 Bill	The 2007 Bill	The 2008 Bill
Ministry that has jurisdiction over NPF Management Committee	MOHW	MOHW	President	-
Number of Members	20	9	7	7
Chair	Minister of Health and Welfare	Non-government member	Non-government member	Non-government member
Government member	6	3	-	-
Non-government members	14	6	7	7
Members representing pension policyholders	12	6	-	-
Experts	2	-	7	7
Number of Resident Members	-	1	1	3
Nomination	-	Pension Policy Consultative Meeting chaired by the Prime Minister (10)	Committee chaired by Minister of Health and Welfare (11)	Committee chaired by Minister of Health and Welfare (11)
Secretariat	MOHW	Secretariat under NPF Management Committee	NPF Management Corporation	NPF Management Corporation
Fund Management	FMC inside NPS	FMC inside NPS	NPF Management Corporation	NPF Management Corporation

The 2003 Bill

The first attempt was made in October 2003 when MOHW proposed a bill to revise the National Pension Act. Major improvements include the followings: (i) reduce the number of NPF Management Committee members from 20 to 9 (three being *ex officio* government members and six being non-government civilian members), (ii) at least one out of six non-government civilian members become full-time resident members (iii) one of the six non-government members serve as the Chair of the NPF Management Committee, (iv) establish a number of standing committees, composed of investment

⁶² See Han et al. (2000).

⁶³ Among many bills to revise the National Pension Act, some came from members of the National Assembly. To save space, I limit my discussion to those submitted by the government.

management experts, to support the NPF Management Committee, (v) establish a secretariat under the NPF Management Committee.

This bill, however, had a serious problem. It proposed to establish a new entity that can jeopardize the independence of NPF management. Pension Policy Consultative Meeting, which is chaired by the Prime Minister and mostly composed of government members, had the power to screen the candidates nominated for the NPF Management Committee Chair. It also had the authority to discuss the basic direction of investment management policies of public pension funds. Given the level of rank of its members in government, it was not hard to predict that many important decisions would be made in this Consultative Meeting. The bill had to face strong opposition by stakeholders and eventually had to be discarded as the National Assembly's four-year term ended in May 2004.⁶⁴

The 2007 Bill

The second attempt was made four years later in December 2007. The main features of the new revision bill include the followings: (i) the NPF Management Committee, which used to be under MOHW becomes a committee under the Office of the President, (ii) reduce the number of NPF Management Committee members from 20 to 7, (iii) six out of seven members are non-resident members that meet strict eligibility standards in terms of investment management expertise, (iv) the NPF Management Committee is chaired by one of its non-resident members, (v) the committee nominating NPF Management Committee members is chaired by the Minister of Health and Welfare and composed of 11 members (five *ex officio* government members, three members representing pension policyholders, and three investment management experts), (vi) spin off the Fund Management Center (FMC) from NPS and establish a separate fund management corporation, (vii) the newly established fund management corporation serves as the secretariat for NPF Management Committee, (viii) the CEO of the newly established fund management corporation serves as the sole resident member of NPF Management Committee.

This bill was as unpopular as the 2003 bill among the NPF stakeholders. First, they were concerned that the new structure of NPF Management Committee being under the Office of the President would endanger its political independence. Second, they feared that removing the members representing pension policyholders altogether would undermine the key achievements of the 1998 Reform. That is, the democratization of NPF management. Third, they were skeptical that the committee, mostly composed of non-resident members with little time commitment, will be able to monitor and control the fund management corporation. This bill was automatically discarded as the National Assembly's four-year term ended in May 2008.

The 2008 Bill

The latest attempt to reform the governance structure of NPF management was in August 2008. The key features include the followings: (i) the NPF Management Committee, which used to be under MOHW becomes a committee that stands alone independent from the executive branch, including the Office of the President and the government ministries, (ii) reduce the number of NPF Management Committee members from 20 to 7 (none of the members being government members), (iii) three out of seven non-government civilian members become full-time resident members (iii) one of the three resident members serve as the Chair of the NPF Management Committee, (iv) all seven members must meet strict eligibility standards in terms of investment management expertise, (v) the committee nominating NPF Management Committee members is chaired by the Minister of Health and Welfare and composed of 11 members (four *ex officio* government members, six members representing pension policyholders, and one member representing

⁶⁴ The same bill was proposed again in June 2004 with the new National Assembly, but discarded again in April 2007.

public interest), (vi) spin off the Fund Management Center (FMC) from NPS and establish a separate fund management corporation, (vii) the newly established fund management corporation serves as the secretariat for NPF Management Committee.

Although the 2008 bill is an improvement over the previous two bills, the bill was opposed by the NPF stakeholders. Again, they feared that removing the members representing pension policyholders altogether would undermine the key achievements of the 1998 Reform. That is, the democratization of NPF management. Another concern was that the NPF Management Committee, completely composed of investment management experts, are highly likely to face conflict of interest problems. The bill allows current heads of major asset management companies in Korea to be appointed as NPF Management Committee members. One cannot exclude the possibility of self-dealing transactions and, in the absence of disinterested members it is not obvious how such transactions will be dealt with.⁶⁵ Lastly, it was feared that NPF Management Committee will fall under the influence of the Financial Service Committee (FSC), and as a result, NPF will be used as a tool to promote financial sector development. According to the bill, there is no government ministry that has jurisdiction over NPF. But, given the professional background of the NPF Management Committee members, it is not hard to guess which government ministry would gain *de facto* jurisdiction over NPF. At the time of this writing, this bill is still at the National Assembly to be deliberated.

VI. Review of NPF Governance vs. OECD Guidance

In recent years the OECD has been looking at public pension reserve funds, in particular at their governance arrangements, including in their report on ‘*Governance and Investment of Public Pension Reserve Funds in Selected OECD Countries*.’⁶⁶ Following on from this work, the Organisation undertook a more detailed assessment of the Korean National Pension Fund’s governance structure in light of the reforms undertaken and further changes proposed.

The OECD supports the establishment of reserves to prefund social security benefits as these funds allow governments to respond to the fiscal pressures from ageing populations (tax smoothing /improving debt position of the government) and international diversification can provide (long-term) exposure to other countries experiencing less of a demographic decline.

In terms of the governance of these funds, the OECD notes that the main feature of public pension reserve funds is that their ultimate beneficiaries do not have legal or beneficial ownership over the fund’s assets – leaving them potentially exposed to state influence (particular as may lack oversight body/ clear objectives/ peer comparisons). The OECD *Guidelines on Pension Fund Governance*⁶⁷ also apply to reserve

⁶⁵ In public corporations, self-dealing transactions can be approved by disinterested outside independent directors. In the absence of such independent members in NPF Management Committee, it is not obvious how such transactions can be dealt with.

⁶⁶ Yermo (2008)

⁶⁷The OECD Guidelines (see OECD 2009) cover the following issues:

I. Governance Structure

“The governance structure should ensure an appropriate division of operation and oversight responsibilities, and the accountability and suitability of those with such responsibilities.”

- Identification of responsibilities
- Governing body
- Expert Advice

funds – but they need additional safeguards to promote better protection from political manipulation – in particular special care over appointment of board (usually contains government representatives).

The OECD therefore supports the 1998 reforms to the National Pension Fund (increasing non-governmental representatives and the market investment of assets). However, further reforms are needed to bring the NPF fully in-line with OECD guidance and international good practice.

Governance Issues

The OECD has made several recommendations regarding the governing body of pension reserve funds – namely preferring a segregated set-up, with an operationally autonomous management entity dedicated exclusively to the administration and investment of reserve assets (as is the case with the Canadian and New Zealand reserve funds, for example).

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 Pension Reserve Fund Commission
Japan	Government Pension Investment Fund (GPIF)	Chairman of the GPIF and Ministry of Health, Labour and Welfare
New Zealand	Guardians of New Zealand Superannuation (a public sector corporation)	Board of the Guardian 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	Norwegian parliament and Ministry of Finance

- Auditor / Actuary / Custodian
- Accountability
- Suitability

II. Governance Mechanisms

“Pension funds should have appropriate control, communication and incentive mechanisms that encourage good decision making, proper and timely execution, transparency and regular review and assessment.”

- Internal Controls
- Reporting
- Disclosure
- Redress

	the ' Norway' fund	
Sweden	AP Fonden	Board of Directors of the AP Fonden

Given that the Management Committee of the NPF in Korea is chaired by the Minister of Health and Welfare, that four other Vice Ministers sit on the Board and that the Ministry serves as the NPF Management Board's Secretariat, it is hard to say that the NFP is operationally independent, and therefore does not fully comply with OECD guidance and international good practice. The Governance structure is further complicated by the Evaluation Committee (which reviews the resolution items and their supporting documents before the Ministry submits them to the Management Committee).

Likewise, the OECD makes recommendations on the membership and selection of a reserve funds Board. These include minimum suitability (non-suitability standards) – such integrity, competence, expertise and professionalism – and the requirement of a collective skill set on the part of the Board to oversee all functions and monitor delegated tasks. The Board should not be too large and there should be a transparent nomination and selection process (such as an independent nomination committee) and termination clauses (involving due process and reason).

Again the NPF does not fully comply with these criteria. For one thing the NPF's Management Committee is too large (20 members being far more than its international peers, most of which have fewer than 15 members, ranging from 7 in Ireland and New Zealand, to 9 in Sweden and 12 in Canada). Though the non-governmental representation has increased, the members do not have specialist expertise. Moreover, the stakeholder organisations represented on the Board are selected by the Minister at his/her discretion and sometimes are politically influenced (for example this issue has been raised in relation to the removal of the PSPD from not only the Management Committee but also the other standing committees of the NPF following criticisms of the current government).

Selection of Governing Body of Reserve Funds

Country	Fit+ Proper	Appointment	Length of Appointment	Removal
Canada	Financial experience etc.	Appointed by Finance Minister from list drawn up by nominations committee	Max 3x 3year term	Only for cause
France	2 of 20 must be experts	2 parliamentary appointees 2 senate/ 4 Ministries/ 5 Unions/ 5 employers	Non-governmental 6 years	
Ireland	Senior level experience in investment, economics, law, actuary etc. No civil servants No bankrupt, fraud etc.	Ministry of Finance	Max 2x 5 year term	Incapable or misbehaviour
Japan	Chairman of investment committee members economic or financial experience	Chair appointed by Ministry Health and Labour		
New Zealand	All board members experience, training and expertise in investment management	Ministry of Finance via nominating committee	Max 5 years	Dismissal by Minister
Norway	Governing body is parliament and Ministry of Finance			
Sweden	All board members asset management expertise	Appointed by government Nominations 2 employees/ 2 employer – Chair and Deputy Chair from these nominations	3 years	

The OECD guidelines also clearly lay out the roles of the different players in a reserve fund's governance. The Ministry or government should set a clear mandate for the fund focusing exclusively on the financing of public pension expenditures, and the fund should have measurable objectives – such as a funding ratio or defined rate of return and related risk objectives over a certain time horizon. Meanwhile, the Board of the fund is the body with the role of setting the strategic investment policy of the fund, whilst the Investment Committee is responsible for the day to day operational management of the assets, including tactical asset allocation changes, and the appointment and oversight of external managers.

In terms of complies, the NPF is now run exclusively for the purpose of financing future pension benefits, and measurable objectives are set out in the Fund Management Guidelines (real economic growth + CPI growth rate + adjustment factor determined by risk tolerance level which is set by a 5 year risk shortfall of 10%).⁶⁸ The Management Committee establish the Fund Management Guideline which covers much of a typical investment policy (fund's role, risk objectives, return objectives, hedging policy ratio, benchmarks, risk management, internal control, performance evaluation, compensation, external management, proxy voting, disclosure etc.). The following year's strategic asset allocation and tolerance bands are in the Fund Management Plan, which is submitted to the Ministry of Finance (which puts

⁶⁸ i.e. risk of 5-year accumulated return being less than 5-year accumulated CPI

together the Fund Management Plan of all public funds and reports to the National Assembly). However, the Management Committee's lack of expertise makes them likely to follow the advice of their Ministerial Secretariat or expert standing committees.

Looking at the Fund Management Centre, this body complies with OECD guidelines (in terms of the transparent appointment of expert members etc.). The Chief Investment Officer of the fund also attends the Management Committee meetings in his ex officio capacity. The governance structure could, however, clarify that the Investment Committee - which is part of the Fund Management Centre – should report directly to the NPF Management Committee. There has also been some discussion of setting up an Investment Advisory Committee, reporting to the Management Committee. Care should be taken that this body does not undermine or conflict with the role of the Investment Committee and Fund Management Centre.

In terms of other governance mechanisms for both pension and reserve funds, the OECD recommends external and internal audits, the use of an independent custodian, and that adequate risk-management systems should be in place (including IT systems, monitoring and external controls and internal oversight mechanisms).⁶⁹ Disclosure is also part of good governance, with the OECD recommending that public pension reserve funds publish their investment policy statement, the annual report and audit, and any reports to parliament.

The NPF in Korea is largely compliant with these recommendations. A risk-management committee exists (currently 7 members, chaired by the CEO of the Fund Management Centre with 5 outside experts appointed by the Ministry). The National Pension Fund Management Regulation (approved by the Ministry) and its Enforcement Rules (approved by the CEO of NPS) have very detailed provisions on how risk management is conducted. The NPF Management Committee sets the overall risk budget, whilst the Risk Management Committee sets the budget for each asset class and their VaR for the overall portfolio and for each asset class. Again the governance structure could be clarified, as currently the Risk Management Committee reports directly to the Ministry whereas, to preserve proper independence, it should report to the NPF Management Committee (which it also does on a de facto basis).

The NPF's performance is evaluated regularly by both internal and external bodies, and internal and external audits are carried out (including by the National Assembly). External, independent custodians are also used. The NPF does disclose its 1 year Strategic Asset Allocation, but not its 5-year plan. The Fund Management Guidelines are published and the yearly Fund Management Plan and results are reported in the National Assembly. The homepage of the NPF discloses fund size, asset allocation and performance on a monthly basis, as well as proxy voting results, details of external asset managers etc. Further information on costs would be welcome (to enable comparisons with international peers).

Currently there is no code of conduct (or ethics) which applies to the NPF Management Committee members, but there has been discussion of this and one may be introduced shortly. The National Pension Fund Management Regulation does have a set of provisions on the ethical conduct of FMC staff (including on conflicts of interest and confidential information), with the Enforcement Rules of the National Pension Fund Management Regulation providing more explicit guidelines (e.g. on personal trading).

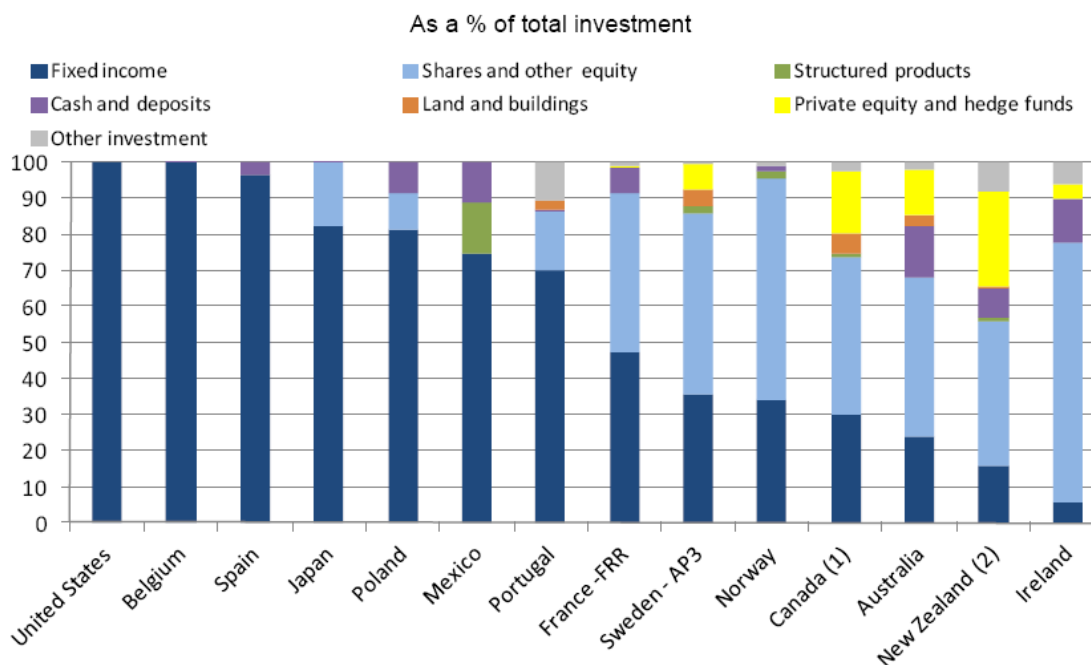
Finally, in terms of recommendations on the investment of public pension reserve funds,⁷⁰ the OECD notes that the funds should follow the prudent person rule, including being properly diversified. Good practice from international peers shows these funds using their long-term nature and scale to increasingly

⁶⁹ Stewart (2010)

⁷⁰ See also OECD Guidelines on Pension Fund Asset Management (OECD 2006)

take advantage of illiquid investment premiums through exposure to asset classes such as private equity and infrastructure, building in-house expertise to do so.

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



Source: OECD Global Pension Statistics.

The NPF still has a high exposure to domestic bonds, which could be seen to contradict the OECD’s diversification requirements. The fund also lags some of its international peers in terms of exposure to alternative investments (target weight 2010 6.4%), However the NPF did established a team dedicated to alternative investments in 2008 (currently 14 staff). The NPF has also dedicated 2.2trillion won to SRI funds and considers ESG factors in proxy voting.

To summarise, the governance of the NPF in Korea did improve with the 1998 reforms, and many of the OECD’s guidelines are followed. Overall, this is a professionally managed fund, with good structures in place. However, the Governing Board needs more independence and expertise. The OECD suggests the following recommendations– which are broadly in line with the direction of the 2008 Bill.

Governing Board

- Set up segregated, dedicated management entity
- Report directly to parliament
- Smaller board all with expertise
- Independent nomination procedure – approved by Ministry
- Strategic Investment Policy set by Governing Board

Investment Committee

- Should report to Governing Board

Other Governance Mechanisms

- Risk-management committee should report to the NPF Management Committee

Investments

- Consider further investment into long-term / illiquid / scale asset classes
- Develop in-house expertise in these assets

VII. Conclusion

The most unique feature about the 1998 Reform is that it was initiated, led, and sustained by an NGO.

People's Solidarity for Participatory Democracy (PSPD), a civil organization founded in 1994, saw NPF's mandatory deposit at PCMF a serious problem and initiated the debate in December 1994 by filing a damage suit against the Korean government. When the window of opportunity opened with the outbreak of the financial crisis in 1997/98, it took the leadership role of organizing conferences, making proposals, and filing a petition to the National Assembly to revise the National Pension Act and the PCMF Act. Many of the suggestions made by PSPD were later adopted in the revised National Pension Act. After the reform, it served as a vigilant watch dog against any attempt to divert NPF reserves for other policy objectives or politically-motivated purposes.

Despite the 1998 Reform, there are remaining issues to be resolved – which have been highlighted through the review of the fund's governance structures vs. OECD guidelines and international good practice. The lack of investment management expertise among the NPF Management Committee members and the lack of its leadership over investment policy pose a serious problem. Korea is now at a juncture where the second wave of governance reform is much needed. The current governance structure is far from adequate to manage a mega-sized pension reserve fund that is expected to grow almost tenfold in the next three decades. Balancing investment management expertise against democratized management, while keeping the management of NPF independent from other government policies or politics are the three key conditions any reform proposal must meet.

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