

Briefing Paper on the Individual Account

Section 1. Role of Individual Account

Background

In 1997 the State Council (Document No. 26) decided to set up a twin pillar basic pension system. This consisted of a Pay as You Go (PAYG) social pool element, ie current contributors would finance current pensioners – which was to be funded primarily by employers' contributions - and an individual account (also known as the China Compulsory Pension Plan (CCPP)) - to be funded primarily by employees' contributions. The pattern of allocation of employer and employee contributions to the social pool and the individual account has undergone several changes since the introduction of the new system. Currently the individual accounts receive all of the employee contributions and all of the employers' contributions flow into the social pool.

In theory the new system is sustainable. But in practice the current system is neither sustainable nor does it function as designed. For the most part the budgetary unit is the city, which is too small a unit to ensure viability. Besides, there is no separate provision for the financing of pre-1997 liabilities, or the "legacy debt". In most cases employee contributions have been used to pay current pensions. As a result most individual accounts are empty or have a shortfall of accumulated employee contributions. In many cases combined employer and employee are not sufficient to pay current pensions and the local government has to bridge the gap from the general revenue. The system is marred by three malfunctions: first, it is too fragmented or decentralised, second, in many localities employers contributions exceed the target ceiling of 20% and, third, individual accounts are largely empty and there is as yet no mechanism to honour individual account liabilities when they become due.

In 2001 the State Council adopted a social security pilot reform programme for Liaoning Province which had been hard hit by the restructuring and closure of many state owned enterprises and where the pension legacy costs have been particularly high. The individual account was recapitalised at 8% involving contributions both from local governments and the Ministry of Finance (MOF). The MOF however has retained its contribution under the management of the central National Social Security Fund (NSSF). In 2004 the pilot programme was extended to Heilongjiang and Jilin provinces albeit at a lower rate of consolidation (5%) with approximately 3/4 of the funding being provided through a reserve fund managed by the NSSF. The Government has subsequently decided to extend the process of consolidation. 8 provinces have been involved in consolidation in 2006 albeit at the lower rate of 3%. The other central component of the pilot reform programme, the upgrading of the budgetary level from cities to provinces, largely remains unrealised.

The Government has decided not to extend the programme in 2007 partly because it wants to focus on raising the basic social pool pension and partly because it is developing a new management and investment framework. However 3 eastern provinces Guangdong, Jiangsu and Zhejiang are negotiating on a consolidation plan that will not involve help from the central government.

Despite the Government policy of supporting consolidation of the individual accounts, alternatives have been suggested including reliance on the PAYG system as the government pillar (supported by wide-ranging occupational and private pensions) and the maintenance of individual accounts on a notional basis (which would in effect supplement the basic pension with an earnings-related / contribution based supplement). The main reasons for and against funding are given below.

Why move to a funded Personal Individual Account?

Arguments for:

1. To improve the credibility of the basic pension system, by explicitly ensuring that funds will be available to pay individuals' pensions. Improving the credibility of the individual pension may also help to reduce the very high amount of personal saving that people undertake and improve the balance between consumption and saving/investment in the economy
2. To provide greater coverage of migrant and flexible workers. A number of pilot pension schemes for migrant workers are based on individual accounts which could be run as part of the basic pension system. A funded individual account would potentially make it far easier to accumulate pension entitlement during periods of work in different provinces and different locations within provinces than under the current unfunded system. It is far easier to implement the portability of pension rights in the case of funded rather than notional accounts.
3. To allow workers to accumulate pension entitlement beyond the minimum contribution period necessary for the basic PAYG pension and to provide greater choice in terms of working longer and saving longer.
4. To provide a stimulus to the development of capital markets. On the government debt side by providing incentives to create long dated bonds as savings to match the length of pension liabilities. Since full account consolidation will be expensive, a high proportion of individual account consolidation will need to be funded through debt issuance (even European governments are looking at the issue of long dated securities). On the corporate side, there is potentially a stimulus both to expand quality corporate bonds, and to broaden the number of shares traded on domestic stock markets
5. Since individual account funds are likely to be managed by large institutional investors who are looking for high standards of corporate governance, this *may* act to drive up corporate governance standards in Chinese companies (although this would require active involvement by fund sponsors and managers in monitoring and demanding improvements in corporate governance)
6. All PAYG systems are under pressure in an ageing society and most governments are looking to introduce voluntary or mandatory individual pension accounts to supplement the basic social pension. Given the healthy state of government finances in China, this is an opportune time move to a funded individual account system (ie to effectively fund the legacy costs of the old system).

Arguments against:

1. To pump even more savings into an economy where the savings rate is already very high may lead to more wasteful investment, because the number of well established investment outlets (eg in real estate or equities) is relatively low. The

domestic stock markets have a relatively low capitalisation in international terms, low amounts of traded shares and a substantial number of poor quality stocks. (However this impact could be mitigated through permitting substantial investment overseas.)

2. To the extent that consolidation is financed by current revenues or taxation increases, it may burden the relatively poor generation of current workers to the benefit of potentially much wealthier future generations (Intergenerational equity)
3. To establish an individual account system could be potentially administratively expensive and in the current weak corporate governance environment of social security could lead to substantial mismanagement and fraud
4. Even in a rapidly ageing society, with the likelihood of real incomes increasing substantially in the next 30-50 years, and the proportion of GDP allocated to wages/salaries likely to grow, the PAYG system actually looks financially very viable provided that either a) the current target level of income replacement is maintained at a sensible level and /or b) pension indexation is linked to price rather than wage growth

The Government has opted to maintain the dual pillar PAYG and funded individual account as a sensible answer to spreading risk. By maintaining a twin track approach there is nothing to stop the Government increasing the relative contribution of the social pool element should the economy (and public finances) grow in the strong way suggested in point 4 above. However although the Government has decided on consolidation, the arguments against consolidation may affect the speed and rate of consolidation given that provinces will require central level funding to achieve consolidation and the Government has ruled out tax increases to fund it.

The other key issue concerning consolidation is where consolidated funds should be held. At the present time the central Government contribution to the consolidation in the three NE provinces has been managed by the National Social Security Fund (NSSF) This is because the NSSF was the only body in a position to realise added value in terms of investment in equities and overseas investments for this fund. However, as provinces start to consolidate and develop requisite investment expertise, should the NSSF continue to manage this portion of the funds? This will be considered in the briefing paper on management.

There are therefore two important questions about consolidation

Question 1 What should be done about consolidation from 1998 to the current time? If accounts should be consolidated what accumulation rate should be used?

Using national statistics on fund accumulation, and a notional accumulation rate of 2.5%, it would cost about ¥ 8.1 trillion to fully consolidate (ie at 8%) individual accounts from 1998 until 2005. The cost per annum is about ¥ 1.5 trillion and will grow as the work force bulges and the number of contributors increases. There are realistically two options:

- a) Not to consolidate the back dated portion and so pay a pension supplement based on a notional individual account accumulation for this period. For contributing migrant workers this could be in the form of a lump sum. The government could set a

date by which it will guarantee full consolidation of IAs (eg Jan 1 2009) even if this takes place over a transition period.

b) To consolidate at 8% or a smaller percentage, and fund the backdated accumulation (for those provinces that could not afford it) through central government contributions and financed by government debt issuance

Question 2 What should the timing and rate of consolidation be for future periods?

The credibility of the funded individual account will be compromised to the extent that it takes a long time to consolidate them and the individual account is consolidated at different rates in different provinces. It may also cause administrative confusion particularly for workers moving across provincial boundaries. The Government therefore needs to come to a view about the affordability of consolidation at 8% going forward, the relative contribution to be made by central government and the extent that central (or local) government contributions should be financed from reallocations of growing tax revenues (especially from VAT receipts) or from enhanced government debt which is a very low level of GDP.

In addition there are further questions on the role of the funded individual account and how it should operate

Question 3 Who will be the administering authorities for the individual account?

There is a strong presumption that these should be bureaux at provincial and large municipality level which are likely to have the administrative capacity to manage the system and sufficient economy of scale to generate large investment mandates attractive for large institutional investors to manage.. If opting for the province and large municipality formula, the government will need to define a minimum number of contributors before the municipality can operate an individual account system with a default option to province level

Alternatively, consideration could be given to a single National Administration Centre for the Individual Account (as for example Sweden has), which would avoid the issues raised in Question 4 below

The Government will need to carefully consider administration costs and in particular whether these will be covered by a percentage levy on each scheme

Question 4 Will individual account holders have any choice about which administering scheme to belong to?

This larger question actually subsumes three related questions:

a) Will individuals have an initial choice about which authority to lodge their individual account with?

This may not be a good idea as it may lead to funds being disproportionately placed with a few large provincial schemes to the detriment of smaller provincial funds. It may also create administrative difficulties through contributing to the PAYG scheme of one authority and the individual account of another. However for large companies operating in multiple sites across China, it may be appropriate to consider allowing individuals to hold their individual account with the provincial / municipal authority where the company has its headquarters. This provision could also be extended to enterprise annuities.

b) If an employee opens an individual account with the first provincial / municipal authority where he / she starts work, will he / she be obliged to transfer accounts if they transfer jobs across provinces or could he / she maintain individual account status with the first authority?

Although administratively this may raise some of the same problems as in a), it may avoid other problems. These include the necessity to calculate transfer values and potentially for the transition period the problem of moving from an authority where individual accounts are fully / partially consolidated to those where they are not (or are only to a lesser extent).

c) Can the employee open individual accounts with several authorities as they move jobs?

This may be offered either as an alternative to transfer, or maintaining an account with one authority, or as an option. This may be attractive for an individual in terms of spreading risk by maintaining accounts with several authorities. However purchasing an annuity from multiple different accounts may be administratively more difficult, though not particularly so, if simple lump sum payments are offered. At the present time, as there are no particular tax concessions for putting money in individual accounts, or increasing contributions above the 8% level, it may not be so important to keep track of individual accounts. This could change if tax concessions were introduced where the amount of money and or /time period of contribution could be limited?

Question 5 What is the target replacement rate for the Individual Account?

The replacement rate is the percentage of the employee's average wage which the pension element, including the individual account, is meant to replace. For the PAYG social pool this is set as 20% of the average wage of the locality. The individual account will allow the replacement rate for the IA component of the pension to be set in comparison to the individual's own salary. The determination of the replacement rate is a multiple of several factors – contribution rate, contribution period, wage growth, accumulation rate and period of pension.

The calculation of the current target replacement rate of 28% for the funded Individual Account is based on a contribution period of 35 years, a retirement period of 10 years and a contribution rate of 8%. Under these funding assumptions the target replacement will be achieved if the annual investment return matches the annual rate of wage growth. In reality however given that wages have risen at a rate of 10% per annum, for 25 years, this rate of return has not been consistently achieved in the

capital market and despite strong recent investment performance represents a very difficult target to achieve over the long term.

Furthermore the average period for payment of pension is now extending well beyond 10 years and the contribution period is only around half that of the target.. This therefore makes achievement of the target replacement rate even harder, and may mean scaling down the contribution of the funded individual account to the overall replacement rate

Question 6 Should the individual account pay a lump sum or an annuity or both?

In several EU countries personal pension accounts pay a restricted amount of the accumulated sum as a lump sum (usually to facilitate clearance of significant debts, such as mortgage liabilities for house purchase) and then a periodic pension. The reason for not allowing full lump sum payments is moral hazard – namely the danger that pensioners could spend all their pension pot and then rely on social assistance from the state. For certain groups of workers with low accumulated sums and therefore the prospect of small monthly pensions (realised either because of few contribution years and / or low wages), eg migrant workers returning to their home village, it may be appropriate to allow a lump sum payment (which may allow the purchase of business or rental of land to provide security). For the generality of workers, however, the payment should be in the form of an annuity, with the *possibility* of a small lump sum (probably 20% or less) payable on retirement (the possibility being dependent on the size of the pension pot).

Section 2 – Investment of the Individual Account

Background

Under existing Government regulations, social security funds including pension funds can only be invested in bank deposits or government securities. As a result, the return on those funds which have been so far accumulated is less than the current rate of inflation which means that the value of accumulated funds in real terms is actually falling. To some extent, the ambition to generate better returns may have been a contributing factor in the ‘Shanghai Scandal’. There would be little point in consolidating individual accounts if it would not be possible to generate returns well above inflation and which would reflect more closely growth in an economy which has been generating GDP increases of nearly 10% per annum for the last 25 years.

If this is to happen, a much wider portfolio of assets must be held. In modern industrialised countries these include, in addition to government securities and bank deposits, company bonds, real property and domestic and foreign equities. In addition, pension funds are also starting to invest in so-called alternative asset classes such as private equity, venture capital, currency and interest rate swaps and using derivatives primarily for hedging purposes. However, the quality of the investment environment in China remains relatively poor, with a relatively small number of company stocks traded on the Stock Exchange (with the danger of an inflationary bubble) and a speculative real estate market. Standards of corporate governance in

the company sector and private companies in particular are low. In terms of future markets, the only existing market is in metals.

Investment strategy involves consideration of three factors – return, risk and time. Return can either be in the form of a capital appreciation (the market traded value of equities for example or real estate) or in terms of the income stream that is generated by the assets held. The capital value of assets and the potential income yield are of course closely connected but due to the role of market expectations and sentiment (the phenomenon of overshooting), at any particular time there may be divergence between the market capital value and the underlying ‘long term’ trend income stream. Because pension schemes are fundamentally about the payment of a regular stream of payments it is the income yield that is ultimately the most important factor in pension investment. However a key aspect of investment strategy is to generate large profits through trading of capital assets which allows successful pension funds to supplement regular income streams from fixed income securities, and outperform market trends in terms of generating returns

Risk – the danger that a targeted return may not be achieved – can be broken down into a number of separate risks These include:

- a) Credit risk – the danger that companies or governments may default on the repayment of bonds, and that the market value will be reduced
- b) Volatility risk – the danger that the returns from the different assets held by the investment portfolio will move in the same direction (eg all equities will move in line with the general stock market)
- c) Concentration risk – excessive holding in any one type of asset.

The objective of an investment strategy is generally to achieve the best return for any chosen level of risk exposure. However, the time dimension comes into play because of the need to maintain liquidity in an asset portfolio to maintain regular pension payments. Therefore, pension funds are less likely to wish to hold assets throughout the period of one or more business cycles unless they have relatively few pensioners since this may increase the need for distress selling of assets at times of a downturn in the business cycle in order to maintain sufficient cash liquidity to pay pensions. For that reason the time dimension and the matching of the duration of assets to future liabilities is an important component of investment strategy.

Pension fund investment strategy has until relatively recently been concerned with performing at or better than the market as defined by a number of agreed market benchmarks. This still remains the most important strategy for defined contribution schemes (which the individual account is) where the value of the ultimate pension benefit will be dependent on the amount of contribution and the accumulation rate. However, to the extent that the Government may specify a minimum return, the individual account may take on in part the character of a defined benefit scheme (where the calculation of the individual pension payment is not determined by the amount of accumulation in the underlying fund). In this situation the focus more recently has been on Liability Driven Investment (LDI) – in other words an investment strategy that is focussed on meeting future pension payment liabilities, not necessarily achieving spectacular returns. LDI tends to result in greater weight being given to fixed income securities over equities and real estate. The extent to which LDI

becomes relevant is in part dependent on how challenging the minimum return target is

In the light of these factors and the fact that the individual account is an individual one, a number of key questions need to be addressed.

Question 1 Should there be an element of individual choice in the assets each individual's account is invested in?

Most individuals have very little knowledge of the capital markets and therefore giving uniformed individuals significant choice over what their assets are invested in may be extremely unwise. The evidence from the US and Japan where workers have been given choice is that there is over-investment in safe low yielding assets (In Japan the average allocation to equity by participants in individual DC schemes is only 20% with half being allocated to bank deposits). One option for providing some choice but limiting confusion is to provide a limited range of funds ranging from the relatively adventurous (much higher weight in equities) to the less adventurous to suit people's financial needs given the time they join the basic pension system. For those who do not select a default option incorporating a life-cycle profile (ie greater investment in equities when younger, and a much greater holding of fixed-income securities when closer to retirement) may be used. This is the case with the so-called generation portfolio offered by the Swedish Premium Pension Authority.

Allowing some choice would introduce more administrative complexity (the need to set up units and unit prices for particular funds) but one which fund managers are highly experienced in dealing with. To the extent that a portion of individual account funds are placed with the NSSF, there will be automatic element of diversification albeit one over which the individual will not in practice have any control.

Question 2 Should there be a guaranteed minimum return?

To the extent that a minimum return is guaranteed, this transfers some of the risk from the individual to the sponsor (in this case the Government). The Government currently does provide a minimum return in the form of the interest rate used for the accumulation of nominal individual accounts. However, the present rate is so low (less than the current rate of inflation and less than the current medium term bank deposit rate) that it is almost meaningless.

If the Government does not allow a choice of funds, it would be reasonable to set some target minimum rate for the individual account; otherwise the individual will bear the whole risk with no option (unlike a private fund) to transfer his / her money into any other scheme. It will also help set benchmark targets for fund managers. On the other hand, there is the danger with any target that fund managers will aim for the target rather than to treat it as a minimum. It will therefore be important that, if setting a minimum return, it should first be reasonably challenging and second there are proper incentives for fund managers to out-perform the target (eg some form of performance based payments for achievement in excess of the minimum. The target will need to be set probably on a rolling basis with reference to particular benchmark rates.

The minimum return could be set and specified annually in accordance with economic conditions, or it could be set as a percentage on a rolling basis so that when individuals retire they can expect as a minimum that degree of capital accumulation for every year of their entitlement. One problem with a minimum on this basis is what to do with any additional accumulation. Should the average excess of accumulation achieved during the individual's pension contribution be credited or should some kind of bonus system of regular and terminal bonuses be used with a proportion of excess accumulation held back to help smooth returns and achieve the minimum return in economically difficult years?

If the Government allows some individual choice of funds, obviously setting target rates may be more problematic because there will inevitably be some individual choice between the level of risk and return that would make setting an overall rate unfeasible. Nevertheless assuming a limited number of funds, it may be possible to set some target rates, either as minimum percentage return for bond weighted funds or as target percentage above the performance of a particularly index (eg 1% above the Shanghai A share index).

Irrespective of whether the Government sets minimum target returns, pension authorities will need to set targets so as to benchmark the performance of their investment managers.

Question 3 Should quantitative restrictions be placed on investment in different asset classes?

There are two main options for regulating the type of assets into which funds can be invested. One is to opt for a quantitative approach setting maximum and/or minimum limits on the percentage of funds that can be invested in particular asset classes (with some outright prohibition on the investment in certain types of assets). The other is to opt for a prudent person approach allowing for the maximum flexibility to be given to experienced fund managers and encouraging local plan sponsors to set limits they think appropriate.

Given the inexperience of sponsoring authorities, the severe consequences of a loss of public confidence in the system which would arise from major losses and the immaturity of China's capital and asset markets, it would seem highly prudent, at least in the short and medium term, to set quantitative restrictions on the investment of the individual account. These could be set as maxima or minima for each asset class with the total adding up to more than 100%.to allow for flexibility in asset allocation There could also be some temporary additional ceiling that would allow investment managers to restructure portfolios without exceeding government set maxima.

Question 4 Should investment in alternate asset classes be allowed?

Despite the growth in alternate assets (such as private equity, interest, venture capital and currency derivatives) even in Europe, there has been relatively little move by pension funds into alternate asset classes. In the UK they make up 2% of the total asset portfolio of pension funds. There are a number of reasons for this – scheme

costs particularly for participation in hedge funds, absence of transparency and the spectacular consequences of failure (eg the Orange County pension scandal in the US where most of the pension fund was lost in a collapsing hedge fund), the longer term nature of pension fund investing which may make trading in derivatives for short term gain (albeit not for hedging purposes) less attractive.

Nevertheless alternate asset classes do offer a credible way of outperforming the market. At the present time given the absence of a Chinese futures market (except in metals) and the problematic nature of hedge funds, it may be appropriate to prohibit investment in these classes. However, it may be worth allowing a small percentage of investment in private equity – partly to help achieve better returns but also with the intentional consequence of ‘weaning’ the corporate sector off bank deposits as the only source of finance and to promote corporate governance. (The NSSF currently has direct investments in 169 enterprises, but only large ones owned by the central Government) One attractive option may be to develop investment in a pipeline of firms, preparing for listing on the Shanghai or Shenzhen exchanges. This would offer the prospect of significant returns as well as an exit route after IPO listing – and at the same time help private firms to prepare for higher standards of corporate governance

Some pension schemes allow investments in local economic development. However given the problems uncovered by the Shanghai Scandal, there should be a strict prohibition on direct investments or through bank intermediaries or fund manager intermediaries in the local economy.

Question 5 Should overseas investments be allowed?

Overseas investment allows the opportunity to diversify investment particularly in equities and corporate bonds where the current supply of suitable companies and opportunities is currently limited in China. At the present time the NSSF has been allowed up to 20% of its funds overseas (¥ 46 billion) although at present initial overseas investment is only about 1/5 of this sum.

Overseas investment offers a number of potential opportunities in addition to expanding the quality of assets that can be purchased. First it offers the opportunity to significantly expand equity holdings in portfolios which at least in the short-term are more limited. In doing so, advantage can be taken of the much higher (although not perfect) standards of corporate governance and financial transparency in established overseas markets. Secondly foreign investment can offer diversification of the asset base and the spreading of risk that could offset downturns in the domestic economy, capital market or currency. Although through globalisation trends in equity markets do tend to follow one another, the experience of Japan in the 15 years between 1990 and 2005 does emphasize that particular economic conditions can adversely affect the investment climate in particular countries

Thirdly it offers a limited opportunity to offset the large net capital inflow, and because China is a heavy beneficiary of Foreign Direct Investment (FDI) most of these funds may flow back again. Fourthly, although the strengthening of the Yuan could diminish the short term profitability of overseas investment, this may matter

less in the long term perspective and in any case is primarily a problem vis-à-vis the US dollar.

It would therefore seem permissible to allow overseas investment in accordance with the NSSF guideline and on the understanding that it will take some time to build up to this level of allocation

Question 6 What are the advantages and disadvantages of an active compared to a passive investment strategy?.

So far this paper has discussed investment strategy primarily as an active strategy – that is making positive decisions to move funds between and within asset classes so as to extract above average returns. However research in the UK has found that on average more than 100% of a portfolio's long term performance can be attributed to its initial asset allocation between the main classes . In other words other aspects of investing such as stock selection and timing have reduced the return that could have been earned from setting the asset allocation and sticking to it. The reasons for this of course relate to the difficulties of timing entry and exits into particular stocks and securities and the transaction costs and possible tax liabilities resulting from relatively frequent transactions.

In contrast a passive investment strategy involves making an asset allocation that mirrors the benchmark index against which you want to measure your performance, and as closely as possible weighting your particular stock / security / asset selection to mirror your chosen index. The advantage of this is much lower transaction costs and and radically reducing the risk of underperforming the market. Such a strategy for example in a rising market such as the Chinese equities in 2005 to the present would have yielded very handsome profits (and did for the NSSF who made returns of 50% on their outlays in 2006). However in a falling or unsettled market , such a strategy may be less attractive,. It also leads to a herd instinct in which particular markets may move between over valuation and sharp falls, particularly if the weighting of the index follows very closely market valuations.

A mid way approach is to adopt a so-called core / satellite approach in which the bulk of funds are managed as part of a passive investment strategy with a significant amount given as active investment mandates to specialist managers to create above benchmark returns. These mandates may in be in particular asset classes. The balance between funds placed in core or satellite mandates will be dependent on the fund's objectives (especially its need to generate above market returns), its toleration of risk, general market conditions and investor choice if this is permitted. In the case of China, at the present time of strong positive market sentiment, the large bulk of funds could be managed under passive investment strategy, with a relatively small amount placed in active mandates predominantly to identify significant *future* opportunities for above market returns (for example in clean energy technology companies).

Question 7 What should the government do to promote the availability of relevant investment instruments?

The Government has been taking some measures to widen the range of government investment instruments. In particular the Ministry of Railways has been using railway bonds as a cost-effective way of financing the expansion and modernisation of the rail network and this potentially offers an outlet for social security funds. (The NSSF has already invested in them.) Nevertheless there is much that could be done in terms of offering long-dated bonds with a coupon rate at or a little below any minimum return (if the Government decides to provide one). Given the Government's very low amount of debt, it is likely that there would be a strong market for such long dated bonds. Providing long dated Government bonds could also provide incentives for the development of a company bond market offering significantly better returns but with higher risk.

The other key area which the Government could work on is developing the equity market and developing the range of equities that are traded on the Shanghai and Shenzhen markets. Nearly all of the company stocks traded on the market are large former SOEs that have been restructured and often contain large government shareholdings. There is an urgent need to broaden the range of companies listed and in particular encourage much wider listing of large privately owned companies.

Background

The move to a funded individual account combined with greater flexibility on how those funded accounts can be invested adds a number of new and complex dimensions to the operation of social security pension funds. These are as follows:

1. Increased data and information needs. The records of pension contributors and beneficiaries will need to reflect investments made (including investment fund choices) and returns from the individual accounts, and at the payment stage the calculation and payments of lump sums and annuities. It may also need to reflect the possibility of transfers between schemes. Many existing IT systems for social security pensions may not be capable of supporting a funded IA system.
2. Greater inter-action with and accountability to individual account holders. Whatever the precise design of the individual account (for example its portability or the element of individual choice of funds), there will need to be much greater inter-action with individual pension contributors. Pension agencies will need to improve their front office, telephone and internet based systems – both in hardware terms but also in customer relations.
3. More Complex Fund Management. Hitherto fund management has been primarily about balancing payments and contributions on a cash basis and ensuring that reserve funds (built up in those authorities in surplus) are invested in bank deposits or government securities. With the advent of funded accounts, there will need to be first a clear separation between the funded and unfunded part of the social pension. Second there will need to be much greater sophistication in combining the long term fund investment objective of achieving the best return for any given level of risk exposure, with the short term objective of ensuring enough liquidity to be able to pay individual account pension benefits in full and on time (and where appropriate) meet transfer costs.
4. New skill needs to procure, contract, manage and evaluate private sector providers. Social Security Bureaux do not have any expertise in fund investment,

nor any realistic hope in the short term of building any significant capacity within the organization to do so. It will therefore need to develop contractual relationships with both fund managers who will invest funds and other private service providers such as custodians, lawyers and advisors who are essential to the delivery of a successful funded pension system

5. A greater attention to fraud and asset recovery. As the system becomes more complex, the possibilities for benefit fraud (especially identity fraud) will increase. Similarly in a situation where there is increasing investment in the corporate sector, the likelihood of corporate fraud (in particular insider trading and the reliability of financial statements) and the possibility of losses will also increase. In the US in 2005 over \$6.7 billion were recovered for aggrieved investors in securities class actions (which may nevertheless represent only around 30% of the total recoverable amount) – and this in a country with better standards of corporate governance
6. Better Social Security Fund Governance. As the Shanghai Scandal and other recent cases of fraud and misappropriation have indicated, the present governance arrangements are wholly inadequate to support a funded individual account system. In particular since the funded individual account system is both mandatory and personal, it is necessary to have properly qualified and motivated representation of individuals from outside the system who are empowered to take and make effective strategic decisions (particularly in terms of asset allocation) on the part of the account holders. Currently there are no structural arrangements in place in the current management of social security to permit this.

Given the current weak governance, accountability and organizational arrangements in the social security system, the launching of funded individual accounts throughout the system demands an ambitious and challenging agenda of management reform. It is not simply enough for sponsoring authorities to have available funds for investment or an investment strategy / plan. However one of the benefits of consolidation may be seen as providing as a big incentive for instituting a series of improvements which will have positive benefits for the whole social security system.

These broad issues raise a number of more detailed questions as to how to proceed

Question 1 When should a sponsoring Authority be deemed capable of managing funded individual accounts?

In most OECD countries, before organisations – be they fund managers or pension plan sponsors - are cleared to set up pension schemes, they are usually required to submit to a detailed external audit and review of their capacity to do so. This external audit will focus on detailed reviews of the areas listed above (and others). Only after passing the review are plan sponsors allowed to proceed to set up their schemes. If plan sponsors have a number of the right elements in place but these have not yet been developed into a comprehensive management system, they may negotiate a time-limited improvement plan with the external auditor to deliver the required changes before a second review. Alternatively in some circumstances, a plan sponsor may be deemed unfit to operate a pension scheme.

Given the possibility of fraud by a number of actors in the system (not simply the plan sponsors) and the weaknesses of the current governance system, it seems essential that each individual account authority undergo a detailed authorization review.

However there is no current existing organization in China which may be qualified to carry out such reviews. The options for carrying out such a review are

1. Special team of independent consultants
2. An ad hoc Government set up under the auspices of MOLSS consisting of National level officials and experts
3. An Office of the Pension Regulator, which would subsequently (as in the UK), supervise the system. Such an office does not exist and would take time to set up.
4. The China Insurance Regulatory Commission (CIRC) (possibly through a temporary extension to its mandate). The latter would have the most capacity of any existing agency within government to carry out such a Review, although some adaptation of its approach may be required for reviewing public social security sponsors.

Each of these options would also attract a financial cost. Given the financial position of the sponsor, this could either be a shared cost or one supported wholly by the local government or by the central government. Some initial review would need to be undertaken in order to avoid the cost of a full review and promote a sense of due diligence and care on the part of the sponsoring authorities. There also needs to be serious consideration of how administrative improvements are to be financed and in particular whether this can be done through a levy on scheme costs

Anything less than full publication of any review findings and / or subsequent improvement plan would be incompatible with promoting the level of good governance and transparency demanded by the Individual Account system.

Given the political sensitivity over the implications of negative reviews, it may be possible that for those sponsoring authorities who have failed the review but have agreed improvement plans can invest in a wider portfolio of financial instruments, including buying into existing direct retail funds (but probably not in equities and not overseas)

Question 2 How can the governance arrangements for the individual account be strengthened?

Current governance arrangements for the management of the individual account fall short of international standards. There is only one supervision committee for social security in each locality and its remit, membership and mode of operation are unsatisfactory. There are 2 particular difficulties in rigidly applying international practice for public pension governance to the Chinese context. First internationally defined governance structures are usually proposed for pension schemes alone, whereas the organizational model in China incorporates other social security functions. The second is the large number of administering sub-national authorities which makes central control of appointments at present impractical and which makes local political influence important in oversight arrangements

Despite this, international models can be adapted to suit the Chinese context. In terms of individual account, international experience would tend to suggest the establishment of an investment committee to be solely responsible for strategic investment decisions (see Question 3) and a general pensions committee to examine wider issues – administration, IT requirements, management of transfers from Social insurance collections, payment of benefits. Given the need to avoid a proliferation of

committees, this committee could also handle and be responsible for the social pool pension. (Similarly the Investment Committee could be responsible for the investment of social pool reserve funds).

It is very important that a strong majority of the members of the Investment Committee are genuinely independent outside appointees (ie not connected in any way with the government of the administering authority), with a majority also having specific experience and technical expertise in the field of investment. The Chair of the Committee should also be an outsider with significant technical expertise and suitable moral standing. In order to facilitate transparency in the selection process the relevant upper tier¹ could appoint a nominations board to seek and recommend appointments to the investment (and other) Committees. The services of outside nominees should be formally contracted and paid for, using standard contracts developed by MOLSS and issued by the upper tier

To retain overall political accountability, it will be necessary that the decisions of the Investment Committee should be approved by the overall Supervision Committee.

Where the overall Supervision Committee does not support the decision of the Investment Committee this fact and the reasons for it should be documented and reported to the upper tier.

In order to ensure that committee members have the skills and ability to carry out their roles, the Ministry will need to provide adequate training and support. In the UK, in addition to specific courses offered by financial service providers, the Office of the Pension Regulator has developed an e learning course for Pension trustees. The provision of adequate training – not just in technical knowledge but also in relevant ‘soft skills’ such as negotiation should not be neglected.

Question 3 How should duties be allocated between Investment and Pension Committee members, LSSBs, social pension agency managers and investment managers?

A critical factor in ensuring good governance is to make sure that there are clear definition of duties which contain neither duplication of nor gaps in responsibilities. The focus of the work of any committee should be strategic direction. For an Investment committee this primarily means strategic asset allocation between the different classes of assets, and the review of performance of fund managers. The Investment Committee should as part of its latter role recommend the appointment, removal or change of mandate of fund managers.

For the Pension Committee this should involve important strategic levels decisions on how individual accounts may be managed eg offering of a choice of funds for investment and how often and in what manner that choice can be exercised, decisions on bonus payments above any government mandated rates of return, and accountability processes with individual account holders

The role of the responsible LSSB is to support strategic management. This would involve supporting the work of Investment and Pension Committee(s) ,(eg engagement of secretarial staff / advisors), approval of all major investments, transfers of collections to Individual Account holding accounts, and general supervision of the Pension Agency

¹ The Ministry for each province and the province for each eligible municipality

The role of the Pensions agency is that of operational management. This would involve the identification of cash flow needs, transfers between holding accounts and Individual Account funds, management of IA account documentation including data transfers from custodians day to day liaison with fund managers and administrators and supervision of asset allocation

The role of the Fund Manager is purely operational within the limits of its contracts. Its two principal roles are the acquisition and disposal of specific stocks, bonds and other assets within the parameters defined by the strategic asset allocations, and performance reporting.

Question 4 How should investment mandates be organized?

The mandate represents the instruction to the manager as to how the investment portfolio is to be managed, covering the objective, asset allocation, comparative benchmarks, risk parameters and performance targets

The starting point for the organization of investment mandates are statements of investment principles on how the organization will conduct its investment strategy, and clear and measurable statements of fund objectives. Mandates can be divided between passive mandates (with longer term holdings that reflect as far as possible the weightings of the chosen market index the mandate is attempting to track) and active mandates (with the objective to find high performing stocks and instruments that outperform the market and which incur higher volumes of transactions).

Until recently it was not considered generally good practice to mix active and passive strategies within single mandates, because their objectives are inherently contradictory. Incorporating activism in a largely equity mandate for example may significantly increase the risk of not achieving the target return with little tangible net benefit in terms of generating additional returns especially if higher transaction costs are taken into account. In this regard organising fund mandates often follow the core / satellite principle (outlined in the background paper on investment) with the relative sizes of the core passive mandates and satellite active mandates being dictated by a number of circumstances including overall target return, toleration of risk, general market conditions and availability of suitable alternative asset classes.

Recently however there has been a move towards combining elements of a more active and passive equity mandates in what are known as 130/30 funds (developed since 2002). The idea is to allow a proportion of the fund to be 'shorted' that is sold and bought back at a later date when the price will have fallen, thus yielding a significant return, and yet still maintaining a long portfolio. This requires significant skill and intelligence in selecting stocks of companies that may have short term problems (eg poor liquidity or poor earnings results but significant long term potential. his strategy has however emerged during a period of rising equity markets and it will be interesting to see whether such funds perform well in the emerging downturn.

In terms of funds under management, mandates need to strike a balance between adequate size and risk diversification. Mandates need to be sufficiently large to allow both a spread of assets for a passive mandate or the opportunity to generate sufficient volume of return net of transaction costs, for active mandates. At the same time there need to be sufficient mandates to allow for adequate risk spread. The NSSF's allocation of 10 mandates for around 1 billion USD worth of funds represents perhaps reflects a slight preference for risk spread particularly to allow for wider performance evaluation.

One approach that is being increasingly used in terms of managing mandates is to use a 'manager of managers' approach. This allows the pension scheme to draw on a potentially wider range of specialist mandate managers to run segregated funds which are then combined by the MOM to form one fund. In addition to allowing greater specialization, the fund also benefits from stronger standards of performance evaluation and a much greater flexibility to respond to change non performing mandates or managers

Question 5 Should any investment mandates be managed in-house?

In general investment mandates are managed in-house for the following reasons

1. To provide direct investment in the local economy (normally a small part of a portfolio) where local knowledge and experience is helpful
2. To run passive mandates particularly for government securities or bank deposits where the expense of doing this through a fund manager is not justified by the returns
3. To provide control performance benchmark against which to measure the performance of external fund managers.

Given the current governance weaknesses of the social security system, it would not probably be a good idea to allow in-house management of active mandates. However it may be reasonable to allow in-house management of a limited number of essentially passive asset classes (bank deposits, short and long term government securities). The proportion allocated to in-house management would reflect the percentage allocations permitted to these asset classes. As part of on-going scrutiny and review process, the number of investment mandates that can be run in-house could be expanded over time, depending on performance in management and governance reforms. However it seems sensible that there should be a minimum percentage of the asset portfolio (probably greater than 50%) which is always run by external managers

Question 6 Should consolidated funds located in the NSSF be reallocated to the Sponsoring Authorities ?

Fundamentally this is of course a political as much as a technical decision. The reasons for keeping central government funds for consolidation under NSSF management are:

1. There is currently no policy framework in place to allow sponsoring authorities to invest funds in the way the NSF can, and even when such a framework is introduced it will take time to build up a requisite level of expertise
2. It provides an automatic element of fund and risk diversification especially given the size of the fund

The reasons against the long term holding of funds within the NSSF are:

1. The NSSF prevents individual account holders exercising any choice over where to place this portion of the funds
2. Since the NSSF is a reserve fund, ultimately its investment policies may be more conservative than that justified by the need to create value for individual accounts

3. The NSSF is a reserve fund and there may be a temptation to use the fund at a later date to balance growing liabilities on the social pool. Rather than to support the funded individual account

Therefore there is certainly a case for arguing that as sponsoring authorities pass critical review tests for competency (possibly after say 3 years of operating a funded individual account), at least a portion of the NSSF is released to the sponsoring Authorities for investment

Question 7 How should fund managers be selected?

The procurement of fund managers needs to follow open and transparent tender procedures, the main usual stages of which are as follows

- Expressions of Interest stage / Requests for Proposals from interested firms
- Drawing up the short list of firms invited to tender
- Developing Detailed Tender Documents
- Evaluation of tenders from short listed companies
- Award of contracts (generally for a length of 4-5 years)

Some of the key considerations in procuring fund manager services are as follows.

1. To what extent do existing Government procurement arrangements and / or normal contract terms may need to be changed (eg purchase of the lowest price services) to allow for differences in the nature of financial services from ordinary procurement
2. Which organization(s) within the Sponsoring Authority (eg the Central Procurement Unit) will handle tender procedures, and to what extent will they need specialist assistance?
3. Who will sign the contracts on behalf of the authority and will they be subject to prior review by for example the Investment Committee and or overall supervision committee?
4. What is the therefore the length of time required for the procurement process?
5. To what extent will fund managers be able to bid for multiple mandates (given this may have implications for risk diversification)?
6. To what extent will fund mandates be issued in separate tranches which will reduce management pressure on contracting / re-contracting and may allow multiple mandates to be held (but none from the same tranche)
7. Linked to the above 2 points is the question of how additional funds may be allocated to existing or new mandates

Considerable care needs to be taken over the selection of fund managers. Many pension funds use specialist investment consultancy services to find not only well established fund managers but also new specialist providers (who are asked to

respond to requests for proposals) Significant budgetary resources need to be allocated for such services to undertake desk based research (including the use of quantitative analysis and manager meetings)², but this expenditure may be justified for large investments in active mandates, where outperforming the market is the critical objective.

In terms of selection of fund managers most pension funds use criteria based on the '6P' approach – philosophy, price, people, processes, performance and procedures. In developing detailed assessment criteria it is important not to weight historic performance too heavily, because of the rapidly changing nature of the market and the changes of skills and experience these new demands. Similarly it is important to ensure that there are proper controls over the activities of individual fund managers and regular engagement with the Pensions Fund (Investment committee) about how the mandate is being carried out. In terms of price, it is likely that the Government may set some maximum price caps as they have done for enterprise annuities³ A key consideration that annual charges laid on fund balances will of course generate very much larger returns for fund managers for any given fixed percentage levy. This needs to be considered in the setting of the initial percentage and whether it may reduce on a sliding scale as asset balances increase..

A key part of any evaluation exercise is to look at the risk of certain eventualities and the ability of the organization to control for that risk. A key risk is the portfolio risk in particular arising from over-concentration in certain sectors or individual company stocks or holding assets where the returns are to a large degree auto-correlate, ie a downturn in one type of asset or set of stocks will generally be accompanied by a downturn in large parts of the company's portfolio. This may be accompanied by a market crash test scenario test – how the fund manager would react to, and attempt to neutralize a big downturn in asset values. A second main risk is the vulnerability of the fund manager to changes in organization (for example takeovers) and the related exposure to a few key individuals (who may leave as a team). Finally the ease of exit – not just in terms of the contractual relationship but also how easily funds may be re-allocated to other portfolio managers is a key consideration.

In all these three risk areas. hedge fund managers carry far higher risk because of the higher risk exposure of their investment portfolio and the general reduced level of transparency of their operations. The use of a fund of hedge funds approach may help diversify risk but at the expense of even less direct control over the usage of funds or exit strategy.

Question 8 How should their performance subsequently assessed? How should non-performing managers be dealt with?

The first building block for a performance evaluation system is having clear and measurable investment objectives, usually expressed against as performance against specific objectives (for example the Standard & Poors 500 or the MSCI Global Equity Index etc). The specification of objectives allows the portfolio to be first broken

² For example, one Australian industry fund uses an investment consultancy which undertakes over 200 reviews each year and makes 8-10 overseas trips a year to interview potential foreign fund managers

³ For Enterprise Annuities, these were set as 1.2% per annum of assets under management, 0.2% for trustee and custodian services, and 5 RMB per month per employee for administration.

down into major asset classes to reflect the decisions of the Investment Committee and then to assign the management of specific asset classes to selected managers who are given a benchmark index as their starting point for decision making and as a measure of success⁴. This approach clearly allows the attribution to reflect asset allocation (for example relative shares of equities or bonds or geographical balance of the portfolio⁵) versus specific asset selection (fund manager responsibility)

The second key building block for the evaluation of performance is clear, accurate and consistent information produced by fund managers themselves. Until recently fund managers had considerable discretion over how they presented performance information, which was unsurprisingly used to show individual fund manager performance in the best possible light for example showing fund manager performance over irregular time periods but ones which showed the manager performing very well relative to others

In belated recognition of the importance of quality and consistent information, the fund management industry (through the Chartered Institute of Financial Analysis) has introduced Global Performance Standards (GIPS).⁶ These standards first introduced in 1999 and revised in 2005 cover the calculation, presentation and disclosure of information relating to investment performance. While not having legal status, many pension funds will not appoint non GIPS compliant firms. Again although it is not mandatory, most firms claiming GIPS compliance are independently verified by external assessors (normally on an annual basis by large accountancy firms, who often act as external auditors)

With these two key building blocks of clear objectives and accurate information, it is then possible to drill down into the segments of the individual portfolio to assess the sources of good and poor performance. For example if a fund manager has a balance fund mandate (equities / bonds) it is important to know whether the weight given to each class by the fund manager within the range specified by the Investment Committee produced a better or lower performance compared to the benchmark.

Similarly one can drill down further to ask whether the share of equities held between different sectors (eg telecommunications, utilities, banks, transport) allowed a better or worse performance than the equity benchmark, or indeed whether particular stock selection provided a better or worse performance within each sector segment.

Similarly the same analysis can be done by looking at the performance of fund manager teams and individual managers within those teams.

While past performance is not always a guide to future performance, poor performance over several periods may raise questions about the way teams or individuals operate mandates. For example are they selling stock too quickly or too slowly in a period of market instability? Are they undertaking too many buying and selling transactions ('churning the portfolio') without significant net return? Are individual stock selections masking poor selection of sectors?

In any case contracts with fund managers should allow for active follow-up of poor performance with fund managers and the rapid removal of individual fund managers

⁴ For a passive mandate this is usually expressed as a tracking error against the chosen benchmark (eg will achieve within 20 basis points a given benchmark in 3 out of the 4 years. For an active mandate this may be expressed as outperforming the benchmark over a rolling three or four year period but not to fall more than 3% below the benchmark in any one year

⁵ For example, Shanghai A shares versus Hong Kong versus Europe versus the United States

⁶ available at www.cfainstitute.org/centre/ips/gips/pdf/GIPS_2006.pdf

and teams. Ultimately the fund must be able to terminate the mandate if performance is consistently poor.

Question 9 How should the additional administrative costs of funding the Individual Account be met?

One of the major issues with the management of the individual account will be the different administrative capacity (and the related fiscal capacity) of different administering authorities. Even if there is concentration of administering authorities at the provincial or large municipality level, this will still leave significant differences in the ability of authorities to access the necessary human and physical resources. This suggests that as the starting point for considering this question, there needs to be an depth review of what it may cost to establish and administer a large pension fund. This could perhaps based on the experience from overseas (the Swedish Premium Pension Agency would be a good example)⁷ and /or large occupational pension providers (eg Sinopec). This work would enable the central government to set minimum administration cost levels, perhaps in specified in terms of per contributor. These would vary with ranges of contributor numbers

It is probably reasonable that partial funding should be provided as a charge on the returns of the scheme. However using a fixed percentage charge on scheme assets or investment income would yield very different absolute sums because of the size of funds under management. Using a flexible percentage will discriminate against smaller schemes which will need to levy higher rates.

The minimum guaranteed funding level less the proceeds of a fixed percentage charge on funds under management would provide a shortfall figure which the central government would make up through a specific grant. If it wished to, it could develop a complete equalization fund in which surpluses over the indicative administration cost level from large well financed schemes could be used to provide subsidies to poorer administering authorities, although this could attract significant opposition from wealthier authorities.

In addition at the start of the consolidation process the government might consider providing special capital funding for IT systems

Grayson Clarke, Fund Management

⁷ The large Industry funds in Australia charge between 1 – 2 USD per week per contributor