A Review of the National Social Security Fund in China

Abstract

One of the major policy developments in China's pension sector in the past decade is the successful establishment of the National Social Security Fund (NSSF).

The NSSF is a strategic reserve fund set up by the Chinese government to mitigate the looming aging crisis in the country and help provide financial protection for the country's pensioners. It is in fact intended to serve as a pension fund of last resort to support those provinces with pension financing difficulties. The National Council for Social Security Fund (NCSSF), a ministerial level entity reporting directly to the State Council, is charged with the responsibility of operating the Fund.

Since its inception in 2000, NSSF has grown significantly in size, stature and influence. By the end of 2008, the total assets of NSSF had reached RMB 563 billion, making it by far the biggest institutional investor in China's pension sector.

This paper provides an overview of the NSSF's background, sources of assets, and investment activities including both its domestic and overseas investment initiatives. The paper also discusses certain design and governance issues at the Fund, as well as their potential ramifications.

Abbreviations and Acronyms

CBRC: China Banking Regulatory Commission
CSRC: China Securities Regulatory Commission
MoF: Ministry of Finance
MoHRSS: Ministry of Human Resources and Social Security
MoLSS: Ministry of Labour and Social Security
NCSSF: National Council for Social Security Fund
NSSF: National Social Security Fund
RMB: Chinese Renminbi currency, also known as Yuan
SAFE: State Administration of Foreign Exchange
SOE: State Owned Enterprise

I. The Looming Pension Crisis in China

China faces a looming crisis to provide old-age pensions for its 1.3 billion citizens. The one-child policy implemented since the late 1970s, combined with improved longevity, means that the population is ageing at a rapid speed. According to data from the UN Population Division, the old age dependency ratio (defined as the number of people aged between 15 and 59 to the number of people aged 60 and above) was 6 in 2005, but will rapidly decline to 2 by 2040[1].

The Chinese government, hoping to build a sustainable pension system, started to implement reforms in the 1990s with the following objectives:

1) to shift the burden of pension provision from the state only, to be shared by the state, employers and employees

2) to move from PAYG financing to a combination of PAYG and funded systems

3) to encourage the development of private sector pensions

4) to expand pension coverage to all urban workers.

After a series of new regulations, pilot programs and revisions, the current Chinese pension model is a five pillar pension system broadly in line with the World Bank's multi-pillar model[2]. The new Chinese pension system, which applies to the urban sector but not the rural community, now includes:

- Pillar zero – a minimum economic support payment provided to people in extraordinary straitened circumstances to ensure their minimum livelihood, with the target group including people: with no labour capability and no income source; with insufficient income source, and their living standard lower than the legal minimum standard; with labour capability, but having temporary interruption of income due to accidents or disasters. No contribution is required for eligibility for this social benefit.

- Pillar Ia – a basic state pension provided through mandatory contributions by employers. Any excess of contributions over benefit payments under Pillar Ia are pooled together at the provincial level and administered by the provincial social security bureaus. Urban retirees will receive pension payments based on average local wage, indexed individual wage and years of employment after a working lifetime.

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[1] UN Population Division, World Population Prospects, the 2004 Revision. http://esa.un.org/unpp/

[2] A more detailed account of the Chinese pension reforms can be found in *Pension Funds in China: a New Look,* by Stuart Leckie and Yasue Pai, ISI Publications, Hong Kong, 2005.

- Pillar Ib – a mandatory individual system funded by employees contributing 8% of their monthly salary. The amount is accumulated in individual accounts earning interest and cannot be accessed until retirement. These assets are also administered by the provincial social security bureaus.

- Pillar II – also known as "Enterprise Annuities" (EA), which are voluntary defined contribution retirement plans set up by eligible employers. These plans are provided through trustees, administrators, investment managers and custodians approved by the Ministry of Human Resources and Social Security (MoHRSS)[3].

- Pillar III – Various other types of voluntary schemes set up by employers which do not conform to the EA format.

- Pillar IV – Voluntary informal family care inherent with the Chinese culture; subsidised healthcare and housing.

However, given the historical pension liabilities accumulated over the decades since the founding of the PRC in 1949, as well as the rapidly deteriorating demographics, these reforms, even when fully implemented, may prove inadequate. A World Bank study estimates that under a baseline scenario with the current pension system, China's implicit pension debt amounts to 141% of GDP, and the financing gap is as much as 95% of GDP[4].

The vulnerability of the system was keenly felt in the late 1990s and early 2000s, leading to some loss of confidence among many Chinese. Even though the regulations at the time clearly stated that Pillar Ia and Pillar Ib assets were to be segregated from each other, many provinces, facing huge benefit payouts and insufficient Pillar Ia contributions, decided to conveniently channel Pillar Ib money to pay Pillar Ia benefits, resulting in a high number of "empty" individual accounts. The problem was most severe in the Northeast provinces of Liaoning, Jilin and Heilongjiang, where the heavy concentration of unprofitable state-owned enterprises meant the provinces had significant difficulties to collect Pillar Ia contributions yet had to pay out significant pension benefits. In fact, workers made redundant were sometimes given full pensions many years before their normal retirement date.

Fearing potential social unrest, the Chinese central government had to step in to support the provinces. New rules were issued with revised contribution rates for Pillars Ia and Ib. The rules also reinforced the segregation of the two pilot programmes in Liaoning and later in Jilin and Heilongjiang; and the troubled provinces were rumoured to be given relief through reduced taxes from the central government to tide over the difficulties.

[3] Formerly known as "the Ministry of Labour and Social Security" (MoLSS).
[4] Yvonne Sin, the World Bank. "Working Paper Series on China: Pension Liabilities and Reform Options for Old Age Insurance, Paper No. 2005-1"; May 2005.

Last but not least, a reserve fund at the national level that could bail out potential provincial pension defaults – the National Social Security Fund – was created.

II. The Establishment and the Administration of NSSF[5]

In late 2000, aware of the looming pension difficulties at the provincial level and concerned about the demographics, the Chinese government established the National Social Security Fund as "a strategic reserve fund" and a "solution to the problem of ageing". The National Council for Social Security Fund (NCSSF), a ministerial level entity directly reporting to the State Council, was simultaneously created to operate the Fund. The NCSSF is charged with a range of responsibilities which include:

- Administer the assets of the NSSF
- Formulate and implement the NSSF's investment strategies
- Select fund managers and custodians for the NSSF assets, and monitor their performance. To the extent allowed by regulations, directly invest NSSF's assets
- Provide financial management and accounting for the NSSF, including the preparation of periodic financial statements and accounting reports
- Regularly disclose to the public the financial condition of the NSSF, including assets, returns, cash flows, etc.
- Distribute funds according to directives jointly formed by the Ministry of Finance (MoF) and the MoHRSS
- Undertake other duties assigned by the State Council.

The NCSSF now comprises 21 executive board members. It is led by a Chairman and three Vice Chairmen, all appointed directly by the State Council. The executive board oversees 9 permanent departments which run the day-to-day operations of the NSSF. In addition to the permanent departments, the NCSSF also oversees three non-permanent committees in charge of investment manager/custodian selection, investment decisions and risk management.

It is interesting to note that many of the NCSSF officials have strong ties with or a background in key government departments including MoF, MoHRSS, the People's Bank of China (PBoC), the China Securities Regulatory Commission (CSRC) and the China Banking Regulatory Commission (CBRC). For instance, Chairman Dai Xianglong used to serve as the Governor of PBoC from 1995 to 2002. Mr. Hu Xiaoyi, Vice Minister of MoHRSS, is currently serving as an NCSSF executive board member. Similarly, another executive board member, Mr. Xiang Huaicheng, used to run the MoF from 1998

[5] The information and data presented in Sections II to IV, unless noted otherwise, is obtained from the NSSF website: www.ssf.gov.cn; or from the annual reports of the NSSF which can be downloaded from the website (mainly in Chinese).

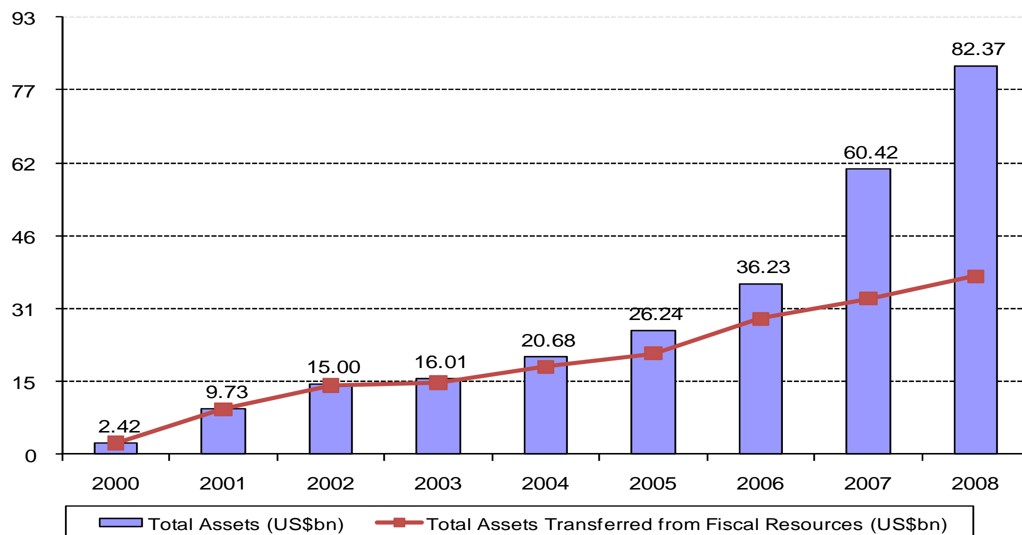
to 2003 before he joined NSSF as the first Chairman of the Fund. The recruitment of senior officials from other agencies is a reflection of the political reality that the NSSF has multiple stakeholders, and that the smooth functioning of the NSSF will require understanding, coordination and compromise among these various agencies.

III. NSSF Sources of Assets

By regulation, the assets of the NSSF come from four sources:[6]

1) Funds allocated from the central government's budget
2) Capital and equity assets derived from state-owned enterprise share sales
3) Other means approved by the State Council (in practice this refers to state lottery licence fees, as well as funds obtained through a securities repo programme)
4) Investment returns.

Figure 1:
NSSF Total Assets at Year End
vs. Total Assets Transferred from Fiscal Resources



Source: NSSF annual reports. Currency conversion at year-end exchange rates.

"Funds allocated from the central government's budget" has historically been the largest source of asset accretion for the NSSF. However, during the past few years, the NSSF

[6] "*The Preliminary Rules on the Administration of the Investments of the National Social Security Fund*" Jointly issued by MoF and MoLSS, Dec. 2001

sources of funds have become increasingly diversified, and the proportion of monies from state allocation has been in decline from 100% of the NSSF's net addition to assets in 2000 to about 19% in 2006 and back to 32% in 2007. That is to say, other sources of assets, especially capital and equity assets derived from allocation of SOE share sales and investment income generated through equity investments, have been increasing in proportion during past few years.

"Capital and equity assets derived from SOE share sales" refers to a proportion of the IPO proceeds arising from the public offering of state-owned enterprises. According to a State Council Regulation issued in 2001 entitled "*Provisional Measures for Raising Funds for NSSF from Divestiture of SOE Assets*", Chinese state-owned companies must contribute 10% of their IPO proceeds to the NSSF at the time of their public offerings. This is essentially a form of taxation on IPO proceeds earmarked for the NSSF. The policy was originally applied to both domestic and international offerings, but it was suspended for domestic offerings in June 2002. After June 2002, assets from this source came only from overseas listings of Chinese companies.

In July 2005, it was approved by the State Council that instead of contributing 10% of IPO proceeds, companies going for overseas listings are required to make a direct transfer of their IPO shares to the NSSF for the sake of NSSF's participation in the long-term growth of Chinese companies. As of 31 May 2008, the total amount of "Capital and equity assets" derived from international offerings stood at RMB89.5bn. In June 2009, the transfer of shares from domestic offerings was resumed, and a total of 131 state-owned companies that conducted domestic IPO since July 2005 are required to transfer the equivalent of 10% of their floated shares to the NSSF. In other words, according to the public notice posted on NSSF's website, those 131 companies are expected to transfer a combined 8.4bn shares to NSSF, with a total value of RMB64bn, without payment.

In December 2006, to better ensure the efficiency and safety of monies the central government granted to 9 pilot provincial governments as a supplement to their individual account funds, NCSSF was assigned the task of managing and investing this money for 5 years. This was shortly after the Shanghai pension scandal was exposed. The 9 provinces are Jilin, Heilongjiang, Tianjin, Shanxi, Henan, Xinjiang, Shandong, Hunan and Hubei. The NCSSF promised a minimum of 3.5% p.a. investment return while no management fee or performance fee will be charged. It was also decided that if the investment return exceeds 3.5%, 50% of the extra money will be saved as a provision to cover any future investment losses. At the end of 2008, the balance of "individual accounts" under the NSSF's management stood at RMB19.8bn (US$2.9bn).

In a nutshell, within a short period of time, the NSSF assets grew almost 35 fold from US$2.4bn in 2000 to approximately US$82bn by the end of 2008, making the NSSF the biggest institutional investor in China's pension sector. On one hand, as demonstrated in Figure 1, the portion of the total assets transferred from fiscal resources (including

allocation from central government budget, assigned state-owned shares, lottery fees and IPO shares) in NSSF's total assets has been declining. On the other hand, the investment proceeds and income from other sources (i.e. security repo programme) have been making an increased contribution to the net addition of NSSF's total assets.

NSSF is now seeking to increase its total assets to US$150bn by the end of 2010, an ambitious target unless it can secure increased funding as well as higher investment returns. However, an enhanced long-term stable funding strategy for the NSSF still needs to be clarified. After pouring in approximately US$12bn from 2000 to 2002, the MoF did not allocate any funds from the national budget to the NSSF in 2003; and the allocation in 2004 fell significantly short of 2000-2002 levels. From 2005 to 2008, the allocation was maintained at the level of RMB10bn per year.

IV. The Investments of NSSF

- **Regulatory Framework for Investments**

The investment activities of the NSSF are governed by two sets of rules:

1) "The Preliminary Rules on the Administration of the Investments of the National Social Security Fund" (The Preliminary Rules) issued jointly by MoLSS and MoF in December 2001
2) "The Preliminary Rules on the Management of Overseas Investments of the National Social Security Fund" (The Preliminary Rules on Overseas Investments) issued jointly by MoLSS, MoF and SAFE in March 2006.

Table 1: Investment Allocation of NSSF Assets

	2000	2001	2002	2003	2004	2005	2006	2007
Total Assets (RMB million) at year end	**20,017**	**80,510**	**124,186**	**132,501**	**171,143**	**211,787**	**282,768**	**439,694**
Self Managed Assets	**20,017**	**80,510**	**124,186**	**100,613**	**109,876**	**138,758**	**177,105**	**232,754**
Bank Deposits	0.6	51,999	93,879	60,017	65,515	102,125	95,165	102,515
Interest Receivables	16	224	1,048	1,446	1,562	1,752	1,754	2,789
Trust Investment Receivables							3	29
Short Term Notes			98	1,073	226	198	199	1,269
Long Term Bonds with < 1 Year Maturity				15,425	4,260	4,216	570	1,570
Long Term Bonds	20,000	27,020	27,895	22,653	26,678	12,737	12,663	39,081
Index Products						3,662	4,293	1,155
Securitization Products						387	972	729
Direct Equity Investments (Bcom, China-Belgium Fund)					11,635	13,682	34,147	38,144
Trust Investments							3,000	18,500
Equity Investments							24,339	26,975
Sinopec IPO Shares / Other		1,266	1,266					
Assets under Third Party Management				**31,887**	**61,268**	**73,029**	**105,664**	**206,940**

Source: NSSF annual reports.

Under the Preliminary Rules, the NCSSF is charged with the responsibility for developing the NSSF's investment strategies and organising the implementation of these strategies. The Preliminary Rules states that the NSSF must stick to the principle of "achieving value appreciation on the basis of ensuring the safety and liquidity of the assets" in its investments.

The NSSF can either directly invest its assets, or appoint licenced investment managers. However, if the NSSF chooses to directly invest the assets, it can only invest in bank deposits or government bonds. For all other types of investments, the NSSF needs to appoint fund managers and custodians approved by the MoHRSS. The Preliminary Rules also details criteria, roles and responsibilities for investment managers and custodians for the NSSF.

According to the Preliminary Rules, no less than 50% of the NSSF assets must be invested in bank deposits and government bonds, no more than 10% in corporate bonds, and no more than 40% in equities and funds. The NSSF often refers to these categories of investments as "low-risk", "comparatively low risk" and "high risk high return" investments, respectively.

The Preliminary Rules on Overseas Investments specify the eligibility criteria of international fund managers and custodian banks in respect of the NSSF's foreign investments.

- **Appointment of Domestic Fund Managers**

From 2001 to 2003, except for a one-time purchase of about RMB1.3bn (US$153mn) of Sinopec IPO shares in 2001, most of the NSSF funds were self-managed and kept in the form of cash and government bonds. Given China's low interest environment, returns on these investments were very modest, hovering between 2% and 3%. Although these returns beat price inflation during that period of time, they were significantly less than China's salary inflation rates. A cash-and-government-bond-only investment strategy is most inappropriate for a long-term pension fund in a rapidly growing economy.

The situation started to change in 2003, when the NSSF appointed 6 domestic fund managers for domestic equity and bond mandates. The managers comprised Boshi (now re-named Bosera), Changsheng, Huaxia (also known as "China AMC"), Harvest, Penghua and Southern, all considered among the best in the Chinese fund management industry. The NSSF 2003 annual report indicates that the amount of assets mandated to these managers was RMB32bn (US$4bn), or approximately 24% of the total assets, at the end of the year.

In 2004, the NSSF further appointed 4 additional managers – CICC, China Merchants, E-fund and Guotai, for "stable allocation" mandates. By the end of 2005, the amount of assets mandated to domestic fund managers had increased to RMB73bn (USD9bn), or approximately 34% of the NSSF's total assets.

The declining equity market in China during 2004 and the first part of 2005 did not bode well for the NSSF's debut equity investments. The NSSF's overall realised returns in 2004 and 2005 were only slightly above 3%.

The situation changed in 2006 and 2007 due to the dramatic rebound of the domestic equity markets. During these 2 years, the major A-share indices were up by 4 or 5 fold, and the realised return of the NSSF was reportedly over 9% in 2006, followed by 38.9% in 2007, most of which was attributed to equity investments.

The bull run in the A-share market in 2006 and the first part of 2007 was followed by a 60% decline in later 2007 and 2008, making it the worst-performing market in Asia. However, NSSF managed to react quickly to the market change and sold out a big portion of its equity holdings within a reasonable period of time. In addition, with a bullish view on the long-term outlook for the domestic financial market, NSSF opened 16 new trading accounts in late 2008 and invested over RMB10bn buying A Shares, which brought the total number of NSSF's trading accounts in the Shanghai and Shenzhen markets to 132.

The NSSF 2008 Annual Report indicates that, as of 31 December 2008, the amount of NSSF's total assets mandated to domestic fund managers for equity investments had increased to RMB60bn, which rewarded the NSSF with a cash return of RMB70bn to the specified date in addition to its stock holdings which were valued at RMB90bn at that time.

- **Strategic Investments in Pre-IPO Shares**

One of the more eye-catching moves during the earlier years of the NSSF was pre-IPO strategic investment into large Chinese companies, especially the banks, at extremely attractive share prices. Given that share prices after IPO tended to be significantly higher than the prices paid by pre-IPO private equity investors, these investments have generated massive windfall profits for the NSSF (although only when shares are sold will the profits be realised).

As the NSSF is a passive investor and could add only limited value in improving the operation or governance of the banks, allowing the NSSF to become a pre-IPO investor and make some "risk-free" profits was a conscious political and economic decision by the Chinese government to help the NSSF boost its returns as quickly as possible.

One of the earliest investments of this kind occurred in June 2004, when the Bank of Communications (BoCom), one of China's more profitable state-owned banks, restructured in preparation for a Hong Kong listing. The NSSF invested RMB10bn (US$1.2bn) as a strategic investor in BoCom, and became the third largest owner of BoCom after the MoF and HSBC.

Similar pre-IPO investments made by NSSF in bigger banks included RMB10bn (US$1.2bn) in the Bank of China (BoC) and same amount[7] in the Industrial and Commercial Bank of China (ICBC), both at extremely attractive prices. The successful Hong Kong listings of BoC in June and ICBC in October of 2006 benefited the NSSF with immediate unrealised returns totaling approximately RMB30.5bn (US$3.9bn)[8]. Given that all three bank stocks have performed well post-IPO, and assuming that the shares have not yet been sold because of a lock-up period, the cumulative unrealised gains for the NSSF in these three banks would approximate US$3bn as at the end of May 2009.

Not all parties agree with the NSSF's aggressive investments in the Chinese banks. Some question whether it is wise for the NSSF to allocate RMB30bn (US$3.8bn), or close to 15% of its book assets, into 3 Chinese banks[9]. The NSSF however, argues that these pre-IPO investments are virtually risk free, and additional investments will go into other banks when they carry out share reforms.

The fourth and also the latest pre-IPO investment made by NSSF is a RMB10bn injection into the Beijing-Shanghai Railway, which could earn a 12% annual return for NSSF once it starts to operate.

- **Involvements in Private Equity**

Since May 2008 the NSSF has been granted permission to allocate up to 10% of its assets to non-state-backed domestic private equity funds. Considering the total capital size of NSSF at the end of 2008, 10% of its asset would be valued at about RMB56bn (US$8.2bn). However, the investments are limited to domestic private equity funds only,

[7] The Chinese media has widely reported that the NSSF's investment in the ICBC was RMB18bn (US$2.25bn). However, according to the ICBC IPO Prospectus published in October 2006, of the RMB18bn paid to the ICBC by the NSSF, RMB8bn was paid on behalf of MoF with the NSSF acting as a custodian to the underlying shares and the MoF enjoying the economic rights of the underlying shares, pursuant to a custody agreement between the two parties. Therefore, the investment made "directly" by the NSSF in the ICBC should only be RMB10bn (US$1.25bn).
[8] Based on information obtained from BoC and ICBC's IPO Prospectuses and IPO Allotment Results in May and October 2006, respectively.
[9] Indeed at current market prices the value of the three bank shareholdings is estimated at well over 30% of total NSSF assets.

meaning the overseas portfolio will still be restricted from venturing into private equity funds for the time being.

This initiative was considered as a significant development in the grand plan of investments for the NSSF and it moved quickly to invest RMB 2 billion into each of two new local RMB-denominated PE funds launched by CDH Investments and Hony Capital. Acting as a limited partner only, NSSF does not take part in the management of the PE funds, leaving the fund managers full flexibility to execute their investment decisions.

The NSSF had previously ploughed money into some government-backed private equity funds, including the China-Belgium Direct Equity Investment Fund and the Bohai Industrial Investment Fund, having obtained special approvals from the regulatory authorities.

As of June 2009, 4% of NSSF's assets are allocated to private equity, and NSSF will reportedly inject another RMB10bn into 3 to 5 private equity funds this year, and even more next year.

- **Overseas Investments**

The NSSF has long lobbied for government approval to allow it to invest overseas, as in fact it started to accumulate significant amounts of foreign capital from the overseas listing of Chinese SOEs. The NSSF hoped that rather than having to convert all such foreign exchange to RMB and then remit it back to Beijing, it could instead keep the cash in foreign currencies and invest this in foreign securities. This would not only lead to better diversification, but also promised higher returns as the domestic equity market seemed to be stuck in a prolonged slump and interest rates were very low at that time.

In October 2003, Xiang Huaicheng, Chairman of the NSSF, formally submitted an overseas investment proposal to the MoF, MoLSS, SAFE, and CSRC as well as the PBoC[10]. The approval process, however, proved to be long and arduous as it involved negotiating with various government agencies, each with its own concerns and priorities. Particularly, the CSRC, the regulatory body that oversees China's securities markets, was worried that allowing the NSSF to invest overseas would reduce investors' confidence in the domestic stock market, which was at the time one of the worst performing in the world. While in early 2004 a decision was made "in principle" to allow the NSSF to make investments overseas[11], the NSSF had to wait for 2 more years before an implementation guideline was issued in March 2006. By this time, the situation

[10] Liu Xuemei, "Xiang Huaicheng's Ambitious Plan: the NSSF to Become the First QDII", 21st Century Finance, 23 October 2004.
[11] Zhao Xiaojian, "The State Council Approves the NSSF to Invest Abroad – a Special Case Rather Than a QDII", Caijing Magazine, 8 March 2004.

had changed – the domestic equity market had already staged a convincing rebound, the massive foreign exchange reserves in China were leading to significant pressure on the RMB to revalue, and new regulations allowing Chinese banks and fund managers to seek client money to invest abroad were imminent. The NSSF at this point had accumulated approximately US$1.6bn or approximately 6% of its total assets in foreign exchange[12].

Once it obtained the regulatory green light, the NSSF acted quickly. It announced that it would invest between US$500mn – US$800mn overseas by the end of 2006. In April, it posted on its website a bidding invitation (in Chinese) for 5 different overseas mandates, specifying eligibility criteria for bidding firms, target returns against benchmark indices and tracking errors, plus a step-by-step review and selection process. In addition, Mercer, as an international investment consultancy, was appointed as the advisor to the manager selection process.

The invitation to bid generated much enthusiasm among foreign managers. Many fund managers believe that although fees would be modest, winning a first overseas mandate from China's No. 1 institutional investor would bring them credibility and long term strategic value in the potentially huge Chinese asset management industry. By the end of June 2006 some 106 managers, a who's who list of the international investment world, submitted expressions of interest. In August, the NSSF short listed 25 managers for further review including face-to-face interviews with the NSSF Expert Appraisal Committee. The Expert Appraisal Committee was made up of 3 NSSF officials, as well as 4 independent Chinese and foreign experts led by Mr. Antony Leung, former Financial Secretary of Hong Kong. In September, the interviews were concluded and the winners were identified. The list of winners was published in late November, after negotiation of fee terms in the investment agreements[13] were concluded.

Table 2: NSSF First Batch of Overseas Mandates

Mandate	Index	Target Net-of-Fees Excess Return p.a.	Tracking Error p.a.
Global (ex-US) Equities	MSCI World (ex USA)	+ 200 bps	Within 8%
US Equities	S&P 500	+ 50 bps	Within 2%
Hong Kong Equities	FTSE/Xinhua Hong Kong	+ 300 bps	Within 8%
Global Fixed Income	Lehman Brothers Global Aggregate Bond	+ 100 bps	Within 2%
Cash	6-month LIBOR	0	N/A

** Source: NSSF.*

[12] General press release for the Second Session of the Second NCSSF Convention, March 2006, published on the NSSF website.
[13] Huo Kan, "Overseas Fund Managers List Approved by the NSSF", First Financial and Economic Daily, 11 September 2006.

Table 3: NSSF First Batch of Overseas Mandate Winners

Mandate	Manager(s)
Hong Kong Equities	Allianz; Invesco; UBS/CICC
Global (Ex-US) Equities	AllianceBernstein; AXA Rosenberg; State Street
US Equities	JanusINTECH; T. Rowe Price
Global Fixed Income	AllianceBernstein; Blackrock; PIMCO
Cash	Blackrock

Source: NSSF.

Separately, the NSSF announced that it had selected Citibank and Northern Trust as global custodians for its overseas investments.[14]

Similarly, as set out in Table 4 below, a second batch of five mandates for overseas investments was posted in March 2008, which again generated huge interest from more than 100 top-tier applicants, though NSSF took a much lower profile for this round of selection. After rounds of interviews and careful evaluation, a list of eight winning companies was chosen in late August 2008, and the NSSF was reported to be in final talks with the selected asset managers regarding various details later last year.

Table 4: NSSF Second Batch of Overseas Mandates

Mandate	Index
Active China Overseas Equity	MSCI China Index
Active Asia Pacific (ex Japan) Equity	MSCI All countries Asia Pacific ex Japan Index
Active Emerging Market Equity	MSCI Emerging Market Index
Active European Equity	MSCI Europe Index
Active Global Equity	MSCI World Index

** Source: NSSF.*

US-based Goldman Sachs and France-based BNP Paribas reportedly have been tapped to be among the selected winners.

In general, the international fund managers have been impressed by the level of professionalism demonstrated in the selection process. Many commented that the process appeared fair and without political interference. It seems that the NSSF, in its selection of overseas managers, has set a new higher standard of governance for other Chinese government agencies and for China's fund management industry generally.

The overseas investments, which currently account for approximately 6% of NSSF's total assets, have only reached less than a third of the Fund's permissible cap of 20% of

[14] Jamil Anderlini, "Pension Fund Picks Citibank, Northern Trust as Custodian". South China Morning Post, 26 July 2006.

total assets so far, but this percentage is set to increase. As a long-term investor, NSSF will surely not wish to forego any significant investment opportunities given that global markets are still valued considerably below their peak levels. In fact, NSSF has been actively preparing a formal proposal to MoF and MoHRSS as regards its future asset allocation into foreign PE funds. Final approval from the State Council is expected to come in the second half of this year and according to the media, NSSF aims to get its first foreign PE deal completed before the year-end.

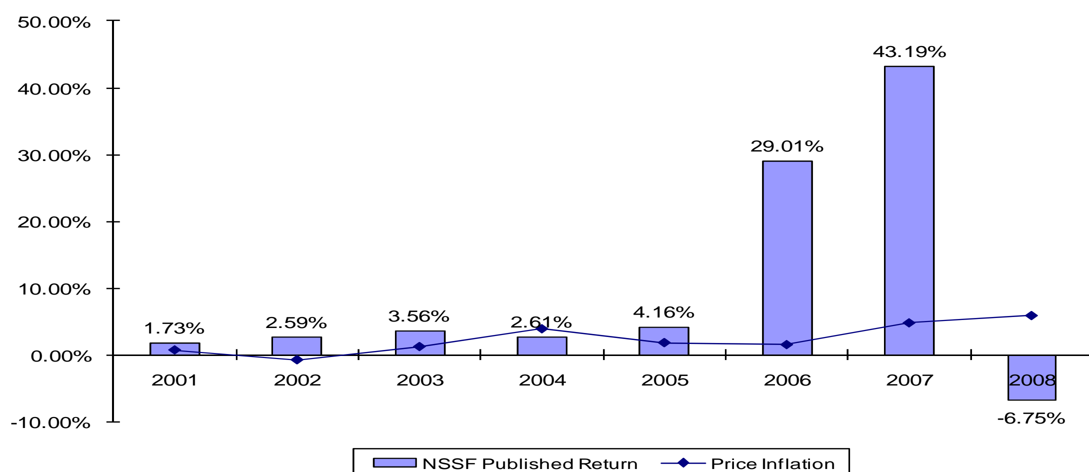
In future, as outlined in one of Mr. Dai Xianglong's speeches, NSSF will look for various ways to further diversify its investments both at home and abroad.

1) Increase equity investments;
2) Increase investments in private equity, especially in infrastructure projects;
3) Reduce allocation in fixed income assets;
4) Increase overseas investments.

- **Investment Returns**

Generally speaking, the returns on the NSSF's investments for the first few years after its inception were modest due to the fact that most of the assets were held in the form of cash and government bonds. However, as of the end of 2008, NSSF had achieved an annualised average return of approximately 9% since establishment, or a total investment profit of RMB160bn (US$23bn)[15]. The year 2007 provided particularly strong growth, as NSSF generated surplus of RMB145bn in that year alone thanks to the booming stock market.

Figure 2: NSSF Annual Return vs. Price Inflation



Source: NSSF website

[15] NSSF website.

It is noteworthy that the returns for the years 2001 to 2007 and the return for 2008 were calculated based on two different sets of accounting principles due to the adoption of the new accounting standards in 2008, and the annualised return of 9% is simply the geometric average of the returns for the years 2001-2008.

V. Controversies and Governance Issues

The NSSF has made significant achievements since its inception in 2000. Its increasing sophistication and its willingness to learn from international best practices have impressed many. However, several challenges remain – some of which are design issues in nature and reflect ambiguities among its founding agencies at the time of establishment. These issues, unless properly addressed, may lead to potential governance problems.

- **Objectives and Purposes**

According to the NSSF website, "the NSSF aims to be a solution to the problem of ageing and serves as a strategic reserve fund accumulated by central government to support future social security needs". Beyond this broad mandate, however, nothing is known about how exactly the NSSF fits into China's pension system. For instance, it is unclear whether the NSSF covers all aspects of social security (pensions, medical insurance, unemployment insurance, workers' compensation, maternity benefits and poverty alleviation) or focuses purely on pension needs. Some western media describe the NSSF as "China's national welfare fund" while most domestic media refer to the NSSF vaguely as "China's national old age pension fund".

The words "strategic reserve" seem to imply that the Fund will be used only in emergency situations such as bailing-out provincial level pension system failures when called upon – yet this guarantee function is not clearly specified – and interestingly, when Liaoning, Jilin and Heilongjiang provinces faced pension difficulties, the central government used fiscal policy, i.e., reductions of tax obligations by the provinces to the central government, to help them tide over the difficulties. The NSSF funds were not actually applied. It is still completely unclear under what circumstances will the NSSF funds be applied, either by way of loan, grant or subsidy.

The lack of clearly defined objectives and purposes could certainly generate false expectations among various claimant groups in the future; and could also potentially lead to misuse of the funds especially under political influence. For example, from the

way NSSF has been investing, it appears that the Fund is increasingly acting like a Sovereign Wealth Fund now instead of a pure pension fund for the nation.

The State Council will need to think very carefully and clearly define the objectives and the purposes of the NSSF as soon as practical. The comment can be made that asset allocation can only be meaningfully considered once the nature and duration of the liabilities is known.

- **Legal Structure**

Another weakness of the NSSF is that it is not established under trust. Although the NCSSF is sometimes described as "acting like trustee", it is nevertheless not a trustee and not bound by China's Trust Law. Consequently, there are no defined beneficiaries for the Fund, and no guidelines regarding distribution of benefits. Fiduciary duty, a key concept of Trust Law, is therefore not binding on the NCSSF.

One reason for the NSSF not being set up under trust may be that the concept of trusts is relatively new in China, as the country's Trust Law did not come into effect until October 2001. However, in contrast, China's more recent regulations on Enterprise Annuities (Pillar II voluntary corporate pension plans) released in 2004 specifies that EAs must be established under trust. By comparison the NSSF legal structure is lagging behind.

Some experts argue that as an alternative to a trust structure, but to achieve the same intended effect, the State Council could pass a regulation that clearly defines the NCSSF's "trust-like" nature including fiduciary duties as well as clearly defining beneficiaries and their rights in written format. This would essentially specify in legal format the key components of a trust structure, including beneficiaries and fiduciary duties, without actually applying Trust Law which remains unfamiliar to most Chinese officials.

Either way, to place the NSSF under trust or a trust-like legal framework would certainly enhance the long-term security of the NSSF.

- **Composition of the NCSSF**

The NCSSF consists of a 21-member board including one Chairman and 3 Vice Chairmen. The Chairman and Vice Chairmen are all directed appointed by the State Council, and the remaining 17 directors comprise either current or former senior

government officials appointed rather than elected to their positions. No external independent director is included in the board.

Internationally, some of the best-run state pension funds have much more transparent and democratic governance structures, which could serve as examples for the NCSSF. For instance, CalPERS, which manages over US$176bn of assets for 1.6 million public employees and retirees in California[16], is governed by a 13-member Board of Administrators including 6 elected member representatives. Information such as board meeting agenda and schedules, election schedules and candidate eligibility criteria and the election process is all published and open to public scrutiny[17].

The board structure of the NCSSF also contrasts with that of listed Chinese companies. The CSRC issued a guideline in August 2001 which encouraged listed companies to have at least 1/3 of their board as independent directors[18]. Some of the more forward-thinking Chinese companies, such as Bank of China and Bank of Communications (both invested in by the NSSF), have already implemented the independent director system and have invited senior international experts to be independent board members.

The inclusion of independent directors in the NCSSF would help the NCSSF to better address any potential problems from various government agencies. It would also help to ensure that the NCSSF resist any political influence that could compromise the purposes of the Fund. If international experts are included, the NCSSF could also benefit from their insights and experience in other markets and improve the overall strategic thinking and decision making at the Fund.

- **Disclosure and Transparency**

The disclosure and transparency of operations and investments results at the NSSF also needs improvement. Currently, data on operations and investment returns are published only once a year in the form of an annual report by the NCSSF, and the annual reports tend to be extremely abbreviated. Furthermore, it seems that the accounts included in the historical annual reports were not audited except for the most recently published 2008 version, which was audited by a Chinese accounting firm based in Beijing.

In addition, a historical cost rather than mark-to-market accounting method was used for reporting up until 2007, which led to concerns about the veracity of the reported results. However, the changes in accounting treatment starting from 2008 are moving towards international practice. For example, the Fund has started to record all tradable and

[16] http://www.calpers.ca.gov/eip-docs/about/facts/investme.pdf.
[17] CalPERS website: www.calpers.ca.gov.
[18] "Guidelines Regarding the Establishment of Independent Director System at Listed Companies", the CSRC, August 2001.

available-for-sale assets at fair value and held-to-maturity assets at amortised cost. Fundamentally, these are more in line with the requirements as guided by international standards such as the Global Investment Performance Standards (GIPS) created by the CFA Institute, and partially this might be due to the influence of overseas fund managers with international equity and bond mandates.

Nonetheless, the adoption of international standard ethical accounting and auditing processes should bring more transparency, objectivity and accountability to the operations of the NSSF, and should help enhance its governance overall in the long run.

VI. Conclusions

The NSSF has made impressive progress in terms of its asset base, sophistication in operations and management, as well as its pioneering efforts in international diversification. It has become the No. 1 institutional investor in China's pension sector, not only in size, but also in stature and influence in China's institutional fund industry. However, design and governance issues remain, which require attention and resolution. The NSSF will need to address these issues in a proactive manner relatively soon to ensure that its long term strategic goals and priorities are not compromised.