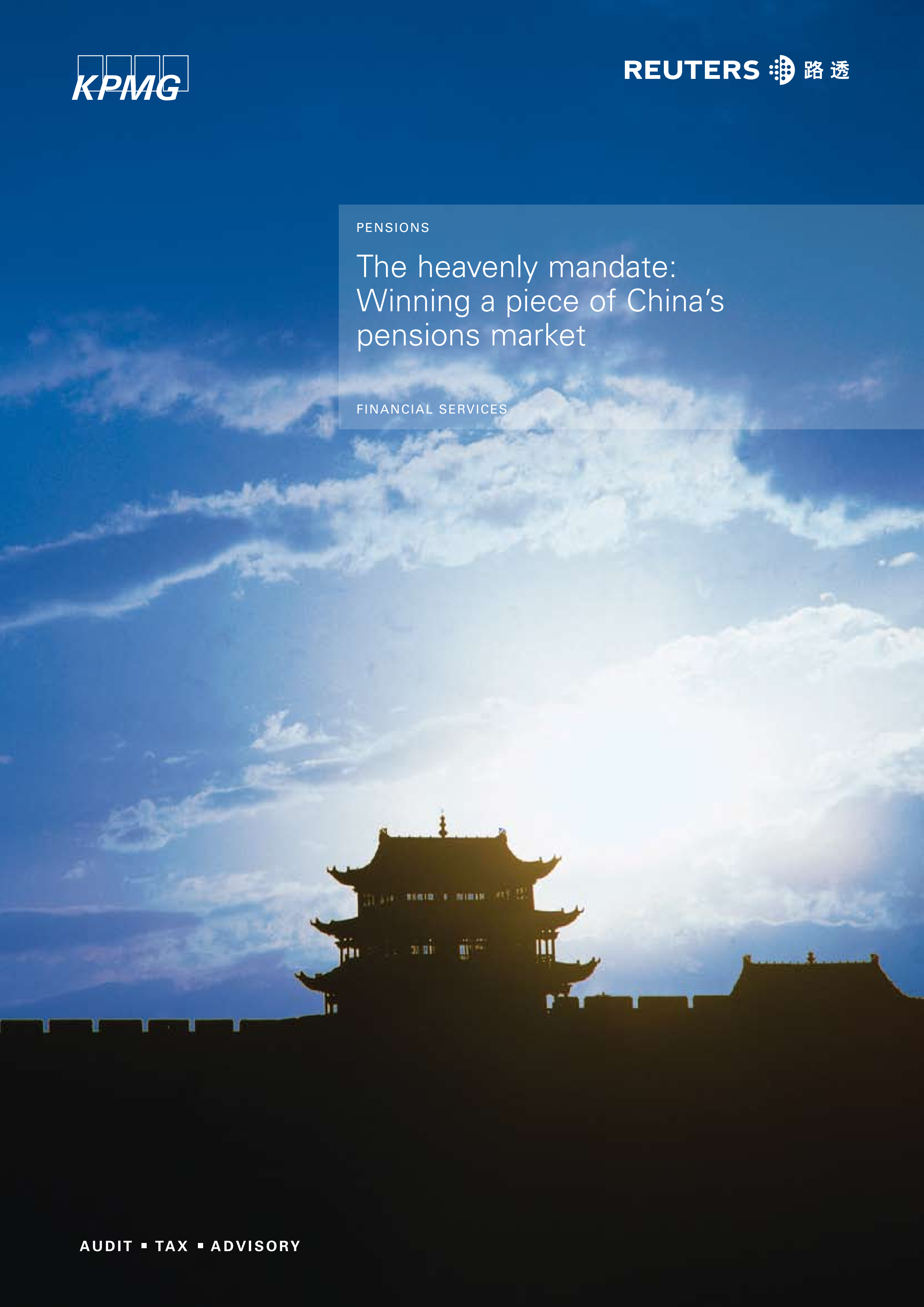

KPMG

REUTERS 路透

PENSIONS

The heavenly mandate: Winning a piece of China's pensions market

FINANCIAL SERVICES

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I am constantly enthralled by the pace of change in China, whether it is in the physical landscape of its cities, the development of its society, or the growing skills of its workforce.

Back in 2001, few predicted that the opening up of China's economy under World Trade Organization (WTO) accession would proceed as smoothly as it has to date. Foreign investors have found new opportunities in a range of consumer and industrial markets, although many have also been surprised by the speed with which their domestic counterparts have responded to the new competition.

In the financial services industry that process is only just taking hold, since many WTO rules will only come into effect later this year or in 2007. There are presently just four foreign fund management companies operating under joint venture arrangements with licences to manage pensions assets. Others will be hoping to follow and win their own mandate, over the coming years. The government has realised the need to move away from state funded liability schemes. A new multi-pillar approach is now in place, but the system may benefit from clearer incentives and uniform tax policies targeting both employees and employers.

That is why it is such opportune timing for us to produce this report on pensions, the latest in a series of collaborative reports on financial services with Reuters. Thanks to the many industry executives and analysts, some of whom spoke off the record, for their insights on this fascinating subject.

Simon Gleave
Partner in charge
Financial Services practice
KPMG in China and Hong Kong SAR

Another joint Reuters-KPMG study on China's financial services sector and I am most satisfied to see us address the critical area of China's pension industry.

Almost all leading economies face serious challenges in supporting the pension promises that governments and companies have made to their citizens and workers, and in the hard choices they are having to make to avoid unsustainable future payments as populations change and age.

China is no exception and in many ways the challenge is much greater. It has been said, with simple but important insight, that while the western economies grew rich before they grew old, China is growing old before it grows rich.

In China, the problems and possible solutions that the pensions sector presents encompass the entire range of political, social, economic and corporate concern.

As we have underlined in our previous reports, it is not a matter of whether China must develop efficient financial services, merely a matter of when, in order to resolve its pressing needs for capital, investment returns, and transparency. And the answer to the question when is most often: right now, if at all possible.

I would therefore like to wholeheartedly recommend this latest report by Reuters' correspondent Jeffrey Hodgson and KPMG staff.

If you are involved in the China pension sector as a business or a potential business, or if you are doing business in any area in China, this is necessary reading. Knowing what is happening with China's pensions sector is quite simply one of the most important things you need to know.

Eric Hall

Editor for North Asia

Reuters

The clock is ticking

This report from KPMG and Reuters looks at the opportunities and challenges presented by China's pension industry for both domestic and international fund managers.

With over 1.3 billion people, an economy growing at more than 9 percent, and an aging population, China is one of the world's biggest potential growth markets for pension funds. If properly developed, it could in time join the United States, Japan, the United Kingdom and Australia as a major centre of pension fund assets – and therefore fees.

China may be developing fast, but its pensions market is in its infancy. The country's US$29 billion National Social Security Fund (NSSF)[1] is a fraction of the size of major pension plans in the United States and Europe, and low even by regional standards. China's pension assets are equivalent to about 5-7 percent of its GDP, compared to about 33 percent in South Korea and 50 percent in Japan.[2]

The fund management industry has high hopes for the fledgling voluntary corporate pension schemes known as enterprise annuities. The framework for this was introduced in the first quarter of 2006. Some describe it as the Chinese equivalent of the U.S. 401(k) plan. But the vehicle has had a modest start because issues like tax treatment and incentives are being cautiously worked out. Pension authorities, to borrow an analogy from the late Chinese leader Deng Xiaoping, are "crossing the river by feeling the stones".

The growth potential has nonetheless caught the interest of foreign investment managers, who regard the pensions market with a mood of cautious and highly qualified optimism.

This briefing paper is based upon interviews with fund industry executives and pension experts from across China. These interviews have been supplemented by extensive desk top research. The briefing paper does not disclose information specific to any company gained during the interview process unless approval has been granted.

1 "China welfare fund to invest abroad soon," Reuters News, 21 September 2006
2 Stirling Finance Ltd.

A nation of savers faces an uncertain future

China faces what experts have called a pension "time bomb," as a result of its unique demographic situation.

By 2050 the number of people aged 60 or over is expected to rise to more than 430 million, or 31 percent of the population, from just 147.8 million, or 11 percent today. This would put it well above the projected world average of 21.7 percent.[3]

More worryingly, the percentage of China's population that is working is expected to peak in 2010, with the ratio of workers to retirees declining from six to one in 2000 to two to one in 2040. This will happen before China can build up enough assets in either its public or private plans to support these numbers of retirees. And more than half a billion rural and urban workers don't even participate in state-run pension schemes.[4]

The World Bank has also noticed the size of China's implicit pension debt (IPD), which is generally defined as the government's obligation to pay future benefits in present value terms. A 2005 World Bank study estimated that under a baseline scenario, China already had an IPD of US$1.6 trillion.

China is getting old before it gets rich.

The root of this problem lies in the one-child policy introduced by the government in 1979 to curb population growth. Many households are now experiencing what has been called the 1-2-4 phenomenon, with one child, two parents and four grandparents.[5]

This lack of retirement security is one reason why China has become a nation of fervent savers, with some US$2 trillion squirreled away in bank deposits.[6] Economists concede that the lack of a sufficiently stable pension scheme is a driving factor behind this. The uncertainty has also had the unwanted repercussion of dampening macroeconomic demand.

[3] United Nations Population Division; www.un.org/esa/population/publications/ageing/ageing2006.htm
[4] "China Goes From Red to Gray," *Fortune Magazine*, June 26, 2006
[5] "*Pension Funds in China - a new look*," by Stuart Leckie and Yasue Pai
[6] "China fund investors dump cash for stocks - report," *Reuters News*, 17 July 2006

A multi-pillared approach

Chinese officials publicly acknowledge that the pension system has fallen behind the needs of a greying population, and the government has taken steps to try to address the problem.

In the 1990s, China revamped its pension system, adopting a multi-pillar model as recommended by the World Bank. The first pillar comprises a mandatory defined benefit scheme, where employer contributions are pooled at a city or provincial level, and a mandatory defined contribution plan, where employee contributions are placed in an individual account.

The World Bank has warned that, as currently structured, both the social pooling and the individual accounts are "financially unsustainable".[7]

Because of the pay-as-you-go structure of the pooled portion, today's contributions go largely to pay current retirees, with nothing left over to finance future liabilities.

The defined contribution part of the plan is theoretically fully funded, meaning the contributions are set aside to accumulate. But in most cases, individual accounts are only partially funded with not enough actual cash in them. Money in these essentially "empty accounts" has been diverted to meet shortfalls in the pooled scheme.[8]

For investors the strongest prospects may lie with the second pillar of the pension system, the nascent enterprise annuities sector. Enterprise annuities are a defined contribution voluntary pension scheme. The assets are under private management, but each scheme must comply with government regulations. The third and final pillar comprises voluntary unregulated schemes.

Industry executives said there are also growing opportunities for money managers to win mandates from the National Social Security Fund, which was established to help local governments that could not meet future pension and other social security payments.

7 *"China: Pension Liabilities and Reform Options for Old Age Insurance,"* by Yvonne Sin, The World Bank, May, 2005.
8 *"China: Pension Liabilities and Reform Options for Old Age Insurance,"* by Yvonne Sin, The World Bank, May, 2005.

NSSF: A strategic reserve fund

The Chinese authorities established the National Social Security Fund in 2000, having long recognised that something needed to be done to meet the shortfall in many local pension schemes. The fund "aims to be a solution to the problem of aging and serves as a strategic reserve fund accumulated by the central government to support future social security expenditures."[9]

The NSSF has become the largest source of business for fund managers operating in China's pension sector. This reserve fund is financed by allocations from the central government and lottery proceeds. It also receives 10 percent of the proceeds from the sale of state-owned enterprises in international markets.

One industry consultancy has estimated that 30 percent of the fund's assets are managed by external firms. It expects assets could climb to RMB 450 billion (US$56 billion) by the end of 2008, creating a RMB 135 billion (US$16.9 billion) pot for the industry to manage.[10]

9 National Council for Social Security Fund website; www.ssf.gov.cn

10 Z-Ben Advisors Ltd., 10 April 2006

A recent development was the decision to let the NSSF begin putting its money to work abroad. Official media reported the fund will start to invest in capital markets outside the mainland in the fourth quarter of this year, including between US$500 million and US$800 million in equities and US$100 million to US$300 million in fixed-income instruments. The fund received applications to handle its money from over 80 investment managers. In May, the NSSF had said foreign fund managers hoping to win mandates to manage these funds must have at least US$5 billion in assets under management and a credit rating of "A" for the past three years.[11]

A better way to fund the NSSF?

China currently allocates 10 percent of the proceeds from initial public offerings of the country's state-owned enterprises in foreign markets to the NSSF. In many cases, this has come in the form of cash, though the fund has also taken allocations of stock, which it can either sell or retain in its portfolio.

But a leading U.S. pension expert thinks there is better way for China to handle the process that could benefit both future retirees and the country's financial markets, while improving corporate governance.

Robert Pozen is chairman of MFS Investment Management, the oldest U.S. mutual fund company. He has served on U.S. President George W. Bush's Social Security Commission and as a visiting professor at Harvard University. He told a Hong Kong business group in March 2006 that China should put a 20 percent stake from all newly listed state companies into the NSSF to help alleviate the country's "pension time bomb".

The NSSF should then be required to hold these shares for at least 10 years, he said, to dispel investor fears that such a big block of shares could be dumped on the market at any point, which may depress prices.

Pozen said that ideally the NSSF's administrators could then begin operating like big institutional investors elsewhere as an advocate for shareholders' rights and improved corporate governance.

"If you had someone with a long-term economic interest, I think that other shareholders would react favourably," he added.

[11] "Chinese welfare fund to invest abroad in Q4," *Reuters News*, 27 June 2006

Enterprise annuities: The next step

Enterprise annuities are the most recent development in the evolution of employer-sponsored pensions in China. While much of the recent focus for fund managers has been on the NSSF mandates, many in the industry expect that within just a few years, enterprise annuities will emerge as the largest source of new funds under management.

The Ministry of Labour and Social Security set the ground rules for these new funds in 2004 and began issuing licences in 2005. To date the government has awarded 15 out of a total of 37 licences to Chinese investment managers, with the rest going to companies providing custodial, trustee, and administration services.

Among the 15 investment managers are four fund management joint ventures with foreign firms. These are:

- Beijing-based Harvest Fund Management Co. Ltd. (www.harvestasset.com), which is 19.5 percent owned by Deutsche Bank AG.
- Shanghai-based Fullgoal Fund Management Co. (www.fullgoal.com.cn), which is 28 percent owned by Canada's Bank of Montreal.
- Shenzhen-based China Merchants Fund Management (www.cmfchina.com), in which the Dutch financial company ING Groep NV holds 30 percent.
- Shanghai-based Fortis Haitong Investment Management Co. (www.hftfund.com), which is 49 percent owned by Belgian-Dutch financial services provider Fortis.

The structure of enterprise annuities is similar to the 401(k) plans that are a major feature of corporate retirement planning in the United States in that both are employer-sponsored. Created in the late 1970s, 401(k) plans have grown to become a leading form of U.S. retirement planning. A major benefit is that the funds can be contributed before being taxed and then grow without being taxed. In many cases, companies match contributions.

Enterprise annuities do not yet enjoy such extensive tax benefits and are more strictly controlled, with limits on where investment managers can put a fund's money. The current tax regime offers little in the way of incentives. However there is some income tax relief for employers' contributions, subject to limits set by local tax authorities.

The system also caps fees. Investment managers can charge up to 1.2 percent of assets under management. But one fifth of this must be allocated to a risk reserve until this reserve reaches 10 percent of assets under management.[12]

Entry to the PRC pension market

Service provider	Trustee	Administrator	Custodian	Investment manager
Who can participate	Trust companies and enterprise annuity administrative council	Institutions with capacity for account administration	Commercial banks or institutions with capacity for fund custody	Fund managers and securities companies authorised by the China Securities Regulatory Commission (CSRC)
Capital requirements	• Registered capital not less than RMB 100 million • Net assets must be maintained at all times of at least RMB 150 million	• Registered capital not less than RMB 50 million	• Net assets must be maintained at all times of at least RMB 5 billion	• Registered capital not less than RMB 1 billion for securities companies; and not less than RMB 100 million for other companies • Net assets must be maintained at all times of at least RMB 1 billion for securities companies; and at least RMB 100 million for other companies
Fees	Up to 0.2% of entrusted assets	Up to RMB 5 per month per account	Up to 0.2% of assets under custody	Up to 1.2% of assets under management (However, 20% of this 1.2% must be allocated to a risk reserve until total risk reserve reaches 10% of assets under management)
Other requirements	In addition to capital requirements, each category of service providers must meet further requirements in terms of the adequacy of their corporate governance, internal control systems, information and operating systems, their legal track records and the qualifications of their staff.			

Source: Regulation No. 23 issued by the Ministry of Labour and Social Security

12 Registration No. 23 issued by the Ministry of Labour and Social Security; www. molss.gov.cn

Equity investments are capped at 30 percent, with direct investment in shares limited to 20 percent. At least 20 percent must be invested in money market instruments. Up to 50 percent can be invested in fixed-income securities, but at least 20 percent must be kept in government bonds.[13]

The expectation within the industry is that this conservative allocation structure will only change gradually. The regulators want to make sure the public's risk-conscious attitudes are reflected in the practice of asset managers. The willingness of regulators to allow more equity exposure is likely to occur in parallel with the development of the country's capital markets.

At present enterprise annuity funds can only invest in mainland Chinese financial instruments. But over time, some in the industry believe China may become more relaxed about allowing enterprise annuities to invest their funds abroad. If that happens, the purely Chinese investment management firms may be able to outsource the management of part of their assets to international fund managers. Their preferred partners may be those who have no tie-up with existing Chinese managers.

Pension people: Andrew He

Assistant president, Fullgoal Fund Management Ltd.

Fullgoal Fund Management already has about RMB 2 billion (US$250 million) in enterprise annuity assets under management, according to Andrew He, assistant president. This included assets transferred from supplementary corporate pension plans that existed before the formal launch of enterprise annuities this year. He predicts that if the right tax incentives are put in place, assets from enterprise annuity schemes could surpass those sourced from the NSSF by the end of the decade.

While the lack of a consistent nationwide tax policy has been an impediment to the development of enterprise annuities, He thought this would change by early 2007, adding; "They will do something to stimulate the market I think. Based on this I am optimistic for next year."

He believes Fullgoal's enterprise annuity business could grow by 30 percent next year if the right changes are made.

[13] Registration No. 23 issued by the Ministry of Labour and Social Security; www. molss.gov.cn

Procedure to establish an enterprise annuity fund

Employer plans the design

↓

Plan filing with local social labour department

↓

Select trustee and sign trustee agreement

↓

Enteprise annuity (EA) council trustee filing[14]

↓

With input from the employer, the trustee selects account administrator, custodian and investment manager(s), and signs service contract(s)

↓

Filing of trustee agreement and contracted service agreement

↓

Obtain EA registration number

↓

Open account with custodian bank for entrusted EA assets

↓

Commence operations:
Contributions, investment management activities and benefits payment

[14] The EA council comprises representatives of employees, management and authorised pension companies

A slow start but a bright future

While many fund industry executives believe enterprise annuities could surpass the NSSF as a source of pension assets to manage by the end of the decade, the program has got off to a slow start. As of May 2006, an estimated 100 enterprise annuity programmes were either implemented or in progress, with money just starting to flow to fund managers.[15]

Some assets have been transferred to enterprise annuities from supplementary corporate pension plans that existed previously. Prior to the creation of the new system, these supplementary plans were estimated to hold at least RMB 70 billion (US$8.75 billion) in assets, under the management of local social insurance bureaux, industry organisations and insurance companies.[16]

The slow uptake of enterprise annuities is due in part to the complexity of the system and lack of public information, and partly due to the lack of significant tax incentives for either employers or employees. Many fund executives are now reluctant to make any long-term predictions about the growth in assets, noting that too many policy-related variables are at play.

15 "China pension time bomb is opportunity for funds," *Reuters News*, 12 June 2006

16 "*Pension Funds in China - a new look*," by Stuart Leckie and Yasue Pai

In addition, many employers are not yet fully aware that each scheme will need to be audited annually by a qualified accountant. This will mean additional cost for employers, not only in terms of contributions but also audit fees and administrative expenses.

Despite these concerns, some believe the value of having an enterprise annuity system in a company is going to rise as Chinese enterprises compete for talent and try to extend goodwill to their staff.

China's Lenovo Group Ltd., the world's third-largest maker of personal computers, announced in July it would establish an enterprise annuity corporate pension plan for its China-based employees, selecting Harvest Fund Management Co. as its investment manager. Fund management companies have also had some successes targeting multinationals from the U.S. and Europe with operations in the country.

International fund managers whose joint ventures have already been approved to manage enterprise annuities' assets say that despite the market's small size, they are gaining invaluable experience that will translate into a larger sales and market share in the future.

Still, some foreign fund industry executives say they are willing to watch from the sidelines as the sector develops. While many expect enterprise annuities to play a major role in the future, they don't expect to lose out by not having the licence immediately.

Establishing benchmarks

With the launch of an enterprise annuity scheme, the players involved must be able to answer certain questions. Plan sponsors need to check that members are getting reasonable returns. Trustees must decide how to choose the most appropriate fund manager and demonstrate they have fulfilled their fiduciary responsibility in doing so. And fund managers must be able to demonstrate their ability to deliver the best risk/return performance if they hope to win mandates.

To facilitate each of these stakeholders, Reuters in March launched the Reuters China Pension Index (RCPI). The RCPI is the industry's first and so far only benchmark index for measuring the investment performance of an enterprise annuity plan.

The RCPI is composed of three foundation indexes, to show what an enterprise annuity investor would earn if their money was placed in purely passive instruments. It is advised by an index committee comprised of Reuters representatives and independent advisors, including industry practitioners and academics. With little track record available to distinguish between funds, the development of such indices could be an important development for the market.

Challenges and obstacles

Tax issues, including the lack of tax incentives, were cited by almost every fund executive as the biggest obstacle to the development of the enterprise annuities market.

China does not yet have a full and clear national tax policy to facilitate the development of enterprise annuities. This has led to uncertainty about the treatment of contributions made by the employee and employer, the treatment of the monies that are accumulating and the treatment of benefits being paid out.

While modest deductions of up to 8.3 percent of payroll are offered to employers at the provincial level,[17] industry executives said a national programme, particularly one offering incentives for individuals, could spur major growth in the enterprise annuities sector.

Executives and analysts said other obstacles include the logistics of setting up the system, which requires the participation of a trustee, administrator and custodian, as well as a fund manager. Lining up these different players can add to the challenge of winning business.

Better internal controls are needed to build trust, by demonstrating adequate segregation of duties and with robust controls and documentation in respect of costs incurred.

[17] "Unifying tax preferential policies on Annuities," *China Business News*, 27 June 2006

On the demand side, the poor financial state of many companies, particularly state companies, means many feel they cannot afford such a plan. And in many cases, because they are behind on payments into the state-run portion of the pension system, they would not be allowed to launch an enterprise annuity plan anyway.

Still, the longer-term potential of the programme should not be underestimated if the right incentives are put in place, according to Stuart Leckie, co-author of Pension Funds in China. He noted that U.S. 401(k) plans grew slowly in their first decade, but "really started to accelerate" after that.

Pension people
Emily Li

Executive vice president of Ping An Annuity Insurance Co.

Ping An Insurance, one of China's largest life insurers, said in June that the company had secured 20 corporate clients on pension services and was close to signing a contract with a multinational corporation in China.

Emily Li says most of its existing clients are big Chinese state-owned companies "which have legacy problems with their retired staff, so they have to rely on outside forces for better solutions." She expects that more foreign companies operating in China will set up enterprise annuity plans as a way to retain employees and thinks the sector could boom in the next three to five years.

"The speed could be as fast as you can imagine as we have seen huge demand for enterprise annuities especially with more and more foreign employers coming to China," she adds.

Outlook: Changing rules and a change of mindset

Even if tax policy changes and money begins to flow into China's pension system, analysts say there is still a problem with how it will be invested. The mood among pension investors is conservative, and this seems unlikely to change in a hurry.

Like China's frugal individual savers, those running the nation's pension plans are expected to remain more focused on avoiding losses than in investing in riskier assets such as stocks that might earn higher returns over the long run.

Some of the conservatism is due to the fact that the employer and trustee are responsible for selecting the fund manager and asset allocation rather than the employee. Many customers insist on a principal guaranteed product and some do not want to invest any money whatsoever into equity markets.[18]

The strict government guidelines on investment, and perhaps more importantly, the deeply conservative attitude of plan sponsors ensure most Chinese pension money will initially flow to cash and bond markets, pension experts say.

Even in a mature market like the U.S., new initiatives and tax incentives take time to gain momentum. That suggests it may take five or ten years until money starts flowing into the equity market in significant volumes and gathering the more substantial long-term returns the economy needs.[19] Industry watchers note a similar situation is already occurring with the NSSF.

Either way, faced with an insecure future where the "iron rice bowl" promised after the creation of modern China in 1949 is well and truly broken, China's population will have to save for a time when they cannot work.

The skill of both China's and the world's fund managers will be needed. And given that even a small stream of pension savings from the world's most populous country could become a flood, global fund managers will have to consider, as they do almost daily on the world's markets, whether the risk of an investment is worth the reward.

[18] "China pensions more focused on risks than returns," *Reuters News*, 13 June 2006

[19] "China pension time bomb is opportunity for funds," *Reuters News*, 12 June 2006

Appendices

Appendix 1: Licensed trustees

Name of company	Type of company	Date of approval
China Credit Trust Company Limited	Trust company	August 2005
CITIC Trust and Investment Company Limited	Trust company	
Huabo Trust and Investment Company Limited	Trust company	
Ping An Annuity Insurance Company of China Limited	Pension services company	
Taiping Pension Company Limited	Pension services company	

Source: Ministry of Labour and Social Security Announcement No. 5 dated 1 August 2005

Appendix 2: Licensed account administrators

Name of company	Type of company	Date of approval
Bank of Communications	Commercial bank	August 2005
China Everbright Bank	Commercial bank	
China Merchants Bank	Commercial bank	
Industrial and Commercial Bank of China	Commercial bank	
Shanghai Pudong Development Bank	Commercial bank	
CITIC Trust and Investment Company Limited	Trust company	
Huabo Trust and Investment Company Limited	Trust company	
China Life Insurance Company Limited	Life insurance company	
China Pacific Life Insurance Company Limited	Life insurance company	
Tai Kang Life Insurance Company Limited	Life insurance company	
Xinhua Life Insurance Company Limited	Life insurance company	

Source: Ministry of Labour and Social Security Announcement No. 5 dated 1 August 2005

Appendix 3: Licensed custodians

Name of company	Type of company	Date of approval
Bank of China	Commercial bank	August 2005
Bank of Communications	Commercial bank	
China Construction Bank	Commercial bank	
China Everbright Bank	Commercial bank	
China Merchants Bank	Commercial bank	
Industrial and Commercial Bank of China	Commercial bank	

Source: Ministry of Labour and Social Security Announcement No. 5 dated 1 August 2005

Appendix 4: Licensed investment managers

Name of company	Type of company	Managed funds at 30 April 2005 (billion units)
Boshi Fund Management Company Limited	Fund management company	31.18
China Asset Management Company Limited	Fund management company	32.34
China Merchants Fund Management Company Limited*	Fund management company	35.15
China Southern Fund Management Company Limited	Fund management company	59.56
E Fund Management Company Limited	Fund management company	22.89
Fortis Haitong Investment Management Company Limited*	Fund management company	15.62
Fullgoal Fund Management Company Limited*	Fund management company	9.34
Harvest Fund Management Company Limited*	Fund management company	19.81
Yinhua Fund Management Company Limited	Fund management company	10.87
China International Capital Corporation	Investment bank	
CITIC Securities Company Limited	Securities company	
China Life Insurance Asset Management Company Limited	Asset management subsidiary of insurance company	
Huatai Asset Management Company Limited	Fund management company	
Ping An Annuity Insurance Company of China Limited	Pension services company	
Taiping Pension Company Limited	Pension services company	

Source: Ministry of Labour and Social Security Announcement No. 5 dated 1 August 2005
* Foreign invested fund management joint ventures

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