Fund management opportunities in China's pension market

Received: 11th April, 2005

Stuart Leckie

is based in Hong Kong and advises on pensions and investments in Hong Kong and mainland China. He was founding Chairman of the Hong Kong Retirement Schemes Association and Futures Commission, and was a director of Exchange Fund Investment Limited, which launched the highly successful Tracker Fund. He has advised the Chinese government on pensions reform.

Yasue Pai

is Director of Research with Stirling Finance focusing on pension reform and asset management developments in the Greater China region. Yasue has worked in emerging markets equity research with NatWest Securities in Hong Kong and with Moody's Emerging Markets Service in New York. She received her BSc in Finance and Japanese from New York University and her MA in International Relations from Johns Hopkins University.

Abstract This paper examines China's current pension system and the potential asset accumulation in its various schemes, and assesses the opportunities for local and international fund managers. It provides an overview of the fund management industry as it exists today, including the role of Sino-foreign joint ventures (JVs), and considers the increasing competition as banks and insurance companies enter the industry.

Keywords: *pension reform; National Social Security Fund; enterprise annuity; fund management industry developments; Sino-foreign fund management joint ventures*

China's pension system

Until the late 1980s, the state, via its state-owned enterprises (SOEs), was responsible for providing generous pension benefits of about 80 per cent of final salary in addition to housing and other subsidies. This was a completely unfunded pay-as-you-go system based on current workers paying for previous generations, a system that was unsustainable as the fundamental structure of the economy started to shift from one dominated by SOEs to one where the private sector is generating an increasingly larger share.

China has a rapidly ageing population. In 1970, the ratio of working age adults to those aged 60 and over was 8 to 1; currently, it is 6.4 to 1; by 2040, that ratio will deteriorate to 2 to 1. This is

attributable to two main factors — the 'one-child policy', plus substantial improvements in life expectancy — leading to a rapidly deteriorating dependency ratio. The so-called 1-2-4 phenomenon — one child, two parents, and four grandparents — is becoming apparent. In other words, each adult who will enter the workforce will be taking care of two parents and four grandparents.

Document 26 — Three pillars

Under these circumstances, the government took steps to reform its pension system into a three pillar system broadly in line with World Bank recommendations¹ where the government, employers and employees

Stuart Leckie
Stirling Finance Ltd,
2202 Tower 2,
Lippo Centre,
89 Queensway, Hong Kong,
PR China.
Tel: +852 2147 9998;
Fax: +852 2147 2822;
e-mail: stuart.leckie@
stirlingfinance.com

Table 1: Document 26 — Three pillar system

	Pillar Ia	Pillar Ib	Pillar II	Pillar III
Type	<ul style="list-style-type: none"> • Mandatory • Defined benefit • Pool at city or provincial level • Pay-as-you-go (eventually partially funded) 	<ul style="list-style-type: none"> • Mandatory • Defined contribution • Individual account • Fully funded 	<ul style="list-style-type: none"> • Voluntary/ Supplementary • Defined contribution • Fully funded 	<ul style="list-style-type: none"> • Voluntary/ Supplementary • Unregulated/ usually no tax benefits • Generally insurance based plans
Who contributes what	<ul style="list-style-type: none"> • Employer contributes 15 per cent (to be increased to 17 per cent) of actual wages, with max and min contributions set at 300 per cent and 60 per cent of city average pay 	<ul style="list-style-type: none"> • Employer contributes 5 per cent (to be decreased to 3 per cent) • Employee contributes 6 per cent of wages (to be raised by 1 per cent every two years to reach 8 per cent by 2005) for a total of 11 per cent 	<ul style="list-style-type: none"> • Employers and employees are encouraged to contribute with tax benefits to be determined by provincial governments expected to be up to 4 per cent for employer contributions 	<ul style="list-style-type: none"> • Employers contribute discretionary amounts
Benefits	<ul style="list-style-type: none"> • Assuming 15 years of contributions have been made • Retirement age of 60 for men, 55 for women • 20 per cent of city average pay indexed to a rate between consumer price inflation and salary inflation 	Amount accumulated in the individual account at retirement divided by 120	Lump sum or annuity at retirement	Lump sum or annuity at retirement

all share the burden of providing for an individual's retirement security. The current framework of this system was issued in July 1997 by the State Council in Document 26, 'Establishment of a Unified Basic Old Age Pension Insurance System for Enterprise Staff and Workers'.

China's pension system, as defined by Document 26, aims to incorporate all enterprise workers and self-employed in the cities and townships. This new system is funded by employers and employees on a mandatory and voluntary basis. Benefits will be a combination of a subsistence level defined benefit (DB), a mandatory individual account based on defined contributions (DC), and a

possible supplementary pension to which both workers and companies contribute on a voluntary basis.

The biggest challenge for provinces in implementing Document 26 was making financial provisions for the existing pension debt. In addition, demographic differences between the provinces made the burden of the system uneven. Provinces with a heavy concentration of SOEs that were undergoing market reform could not meet the benefit payments under social pooling.

Also, permitting early retirement of SOE workers hid the unemployment problem but added an extra burden to

pension obligations. It is estimated that three-quarters of China's 31 provinces have not been able to properly fund the individual account part of the state system. In such provinces the payments to existing pensioners exceed the employers' contributions to the first pillar in the system, and so all or some of the money which should go into the individual accounts is diverted to pay current benefits. Interest still has to be added on to the individual accounts each year, however, and after retirement the individual account pensions have to be paid with real money.

To address the challenges of implementing Document 26, in December 2000, the State Council issued Document 42, 'The Pilot Program for Improving Urban Social Security System'.

Liaoning experiment and more recent developments

The major objectives of Document 42 were to adjust and perfect the unified pension insurance system stemming from Document 26.

In July 2001, the government decided to pilot Document 42 in Liaoning, a province with 42 million people in the northeast, which is home to one-tenth of the country's large- and mid-sized SOEs.

Under the pilot programme, retirees will no longer have to get their pension from their former enterprises as they did with Document 26. Instead, the province will pay their pensions regardless of whether the SOE that employed them can afford to or not. A large part of the funding shortage will be met by the central government during the three-year period of the experiment.

Contributions and distributions will differ from those specified by Document 26 as follows:

- (a) pension benefits under Pillar Ia will increase to 30 per cent of provincial average wages after 30 years of employment;
- (b) all employer contributions go to Pillar Ia; and
- (c) Pillar Ib will be funded entirely by employees with eight per cent contributions and will contain real assets, not notional accounts.

The Liaoning experiment is successful in terms of separating the social pool contributions from the individual account contributions so that the latter is a funded pillar. Now that assets are accumulating in individual accounts, the next challenge is to invest these assets so that they earn returns that keep pace with wage inflation. Currently, the accumulated assets are invested in deposits and government bonds. But the Liaoning government is reportedly exploring the possibility of outsourcing the investment management function to private sector asset managers.

With lessons learned from Liaoning, two other northeastern provinces, Jilin and Heilongjiang, have started piloting their version of Document 42 as of May 2004. The Jilin pilot is guided by State Council Document 35 and the Heilongjiang pilot is guided by Document 36, although the contents of the two documents are identical.

It seems that these documents were purposely written as vague, directional guidelines to leave room for detailed measures to be adopted during the implementation stage which extends to the end of 2005. Even so, these documents do address two of the outstanding issues that are important factors in building a rational, sustainable pension system but that were unaddressed by Document 42.

First, the change in the calculation of the basic social pool pension under

Documents 35 and 36 discourage early retirement and give incentive for late retirement, therefore staving off the decline in the system dependency ratio. Secondly, the new calculation method for the individual account benefit takes into consideration the actuarial assumptions. Instead of calculating these benefits based on the 120 factor as is the current practice regardless of the age at which an individual retires, Documents 35 and 36 provide a schedule of retirement ages with corresponding actuarial factors for benefits calculation.

Documents 35 and 36 also point out the need for individual account assets to seek diversified channels for investment to increase the investment returns of the accounts but do not suggest methods as to how this should be achieved.

Despite the lack of details at this preliminary stage, the general direction of these amendments is an encouraging sign that the system is reforming in a way that makes economic sense.

National Social Security Fund

In September 2000, the National Social Security Fund (NSSF) was established under the auspices of the State Council. In the event that some provinces have insufficient funds for Pillar Ia and Ib, the NSSF is a 'fund of last resort'. Money comes into the NSSF from the central government and from the sell-off of state-owned shares equal to 10 per cent of all initial public offerings (IPOs) and rights issues. This latter policy was suspended for domestic issues (but not for international fund raising), because of weakness in the stock markets. The IPOs of PICC Property and Casualty Company and China Life Insurance Company are two examples where the companies raised US\$800m and US\$3.48bn, respectively, and 10 per cent of the money raised was remitted to the NSSF in 2003.

As at end of 2004, the NSSF had approximately US\$20bn in assets, invested predominately in deposits, government bonds, low risk corporate and enterprise bonds, and a small percentage in stocks. Since early 2003, the NSSF has out sourced approximately US\$6bn to a select ten local fund managers. The funds, which are invested in equities, bonds and T-bond repo contracts, are expected to achieve returns of three per cent or more over the consumer price index, and at least 20 per cent higher than the one-year yuan deposit rate.

Enterprise annuities

Under Document 42, the government stated that it wishes to encourage employers to establish an 'enterprise annuity' (EA) scheme for their employees. Enterprise annuity is the term used by the Ministry of Labour and Social Security (MOLSS) for a supplementary pension plan.

According to the document, an EA is a DC arrangement with funded, individual accounts. Both employers and employees can contribute to the fund, but employees are not required to do so. Contributions by the employer are expected to be tax deductible up to four per cent of payroll. The account balance will be paid at the statutory retirement age, at which point the balance is payable as a lump sum or an annuity.

Pursuant to Document 42, the MOLSS issued Regulation 20, 'Trial Measures for Enterprise Annuities', and Regulation 23, 'Trial Measures for the Management of Enterprise Annuity Fund'. These documents, which came into effect from 1st May, 2004, set out the regulatory environment under which EA should now be established. Accordingly, EA plans must be set up as a trust and managed by qualified

investment managers, which in today's market may include licensed investment management companies, trust companies, asset management subsidiaries of insurance companies and securities companies that are authorised to manage separate accounts.

The MOLSS as well as influential industry bodies are keen on promoting this voluntary pillar, which further shifts the responsibility for retirement towards individuals and employers. The more successful this voluntary Pillar II, the better the overall protection for retirement social security among the uncertainties of Pillar Ia and Pillar Ib.

Fund management industry

China's fund management industry began informally in the early 1990s following the opening of the Shenzhen and Shanghai stock exchanges. But it was not until the issuance of the Interim Measures for Management of Securities Investment Funds (Interim Measures) in November 1997 that the industry set off on the rapid development path as we know it today.

As at the end of December 2004, there were over 40 licensed fund management companies in China, mostly operating in Shenzhen and Shanghai, with a few in Beijing and Guangzhou. These firms manage 160 investment funds in China, comprising 54 closed-end funds and 106 open-ended funds. The total assets under management in these funds is still modest at US\$40bn, with equity investments accounting for approximately eight to 10 per cent of the Shanghai and Shenzhen market free float, but the industry has been growing rapidly during its short history and is expected to continue to do so. As in other markets, the fund management industry is expected to serve as the much needed intermediary

to bridge individual savings with long-term capital need of industries, and in China's case, state owned enterprises. Given China's vast savings pools, estimated at US\$1.5tn, the growth potential for the fund industry seems tremendous, with forecasts from industry participants of 25 per cent year-on-year growth for the coming decade. In addition to household savings, another area that is opening up to the industry is pensions. On top of the US\$20bn NSSE, there are also the supplementary pensions, or enterprise annuities, which represent an even bigger opportunity for fund managers. Now that interim regulations have been introduced for enterprise annuities, fund management companies are closely following the developments.

Historical developments

By the end of 1993, just two years after the establishment of the Shenzhen and Shanghai stock exchanges, there were over 70 closed-end funds in existence with Rmb8bn of assets. Some 27 of these funds were listed either in Shenzhen or Shanghai and followed regulations issued by the respective exchanges. A handful of the funds received approval from the People's Bank of China (PBOC) which at the time was responsible for regulatory oversight of all financial market activities. But the majority of the funds traded in local over-the-counter (OTC) centres in an unregulated environment, investing in listed and unlisted companies as well as real estate ventures. Exposure to listed companies averaged about 30 per cent of total investments. Without a clear set of regulations to guide the operations of the fund management industry and without an appointed regulatory body, fund managers administered their funds in a way that was convenient to them, not

always good for the investor. For example, some managers acted as custodians for the funds they managed, and in some cases the net asset value (NAV) for funds were published only once every six months, and there were no standards for portfolio valuation or information disclosure.²

Regulations

The interim measures issued by the China Securities Regulatory Commission (CSRC) in 1997 set out guidelines for the establishment, management and supervision of closed-end and open-ended investment funds on a national level. Based on these guidelines investment management companies must be approved by the CSRC before they can manage retail funds. The major shareholders of a fund company must be securities companies and/or investment companies that have at least three years of operating profit. The minimum registered capital for a fund management company was set at Rmb10m. In addressing the issues that existed with the unregulated funds, the interim measures required that client assets be separately held from those of the fund company by licensed custodian banks. Whereas in the past fund NAVs were only published once every six months, the interim measures required them to be calculated and published at least every month. Investments were limited to liquid and publicly traded securities and all funds were required have at least 20 per cent of net assets allocated to government bonds.³

Although the interim measures set guidelines for closed-end and open-ended funds, in October 2000 the CSRC issued the interim measures for Management of Open-ended Securities Investment Funds which further detailed regulations for the establishment,

management and supervision of open-ended funds.

After numerous drafts, the Securities Investment Funds Law which is based on the interim measures was promulgated on 28th October, 2003 and came into effect on 1st June, 2004.

Earliest fund management companies

Between 1998 and 1999, ten fund management companies were approved for operations based on criteria set by the interim measures. These ten companies (the 'big ten') all have strong financial backing, with shareholders from securities companies, and continue to dominate the industry in terms of market share.

Closed-end funds

The only funds that were launched after the issuance of the 1997 interim measures were closed-end funds. From the regulator's stand point, one major targeted objective of launching closed-end funds was to give support to the depressed stock market at the time. Also, closed-end funds are easier to administer and manage, and being similar to exchange listed securities they are easier to supervise as well. The fact that some developed markets initiated their fund management industry with closed-end funds also gave the CSRC confidence to follow a similar path.

Partly due to the low interest environment, lack of investment alternatives and a booming stock market at the time, the first batch of six closed-end funds were all successfully launched at US\$240m each in 1998, which was substantial for fund managers with no track record. This was followed by a second batch of eight funds launched at US\$360m each in 1999. Another factor that contributed to the positive performance of the initial sets of

Figure 1: Total AUM as at December 2004

Source: Harvest Fund Management

funds was the support from the CSRC in terms of allocations of new share offerings to these funds to ensure good performance.

The closed-end fund market grew at a rapid but controlled pace until 2001, reaching US\$9bn with 36 funds launched. Reports of insider trading and price manipulation at fund management companies in late 2000 led the CSRC to conduct investigations that revealed trading irregularities at eight of the ten fund management companies in existence at the time. These revelations triggered a crisis of confidence among investors in closed-end funds. Closed-end funds launched after this period were no longer guaranteed to be successful.

Open-ended funds

Unlike closed-end funds whose shares are fixed in number, and which may trade above or below their NAVs depending on market demand for the fund, and cannot be redeemed until their expiry date, open-ended funds trade at or close to their NAV and

shares can be issued or redeemed anytime. In China, all closed-end funds are contractual, structured through agreements. Meetings of the predominately retail shareholders are seldom held and very little protection is provided to them otherwise. The redemption feature of open-ended funds should pressure fund managers to act in the best interest of investors.

Since 2002, no more closed-end funds have been issued and the CSRC has focused on promoting open-ended funds.

Industry overview

Since 2001, growth in assets managed by the fund management industry has generally come from open-ended funds. In the four years since the first open-ended fund was launched, the number of funds and total assets under management has risen to 106 and US\$30bn, respectively, as at the end of December 2004. This is in strict contrast to closed-end funds sector which has been stagnant since 2001.

While there are more than 40 asset

Figure 2: AUM products segmentation as at end of December 2004

Source: Z-Ben Advisors, 7 February 2005

management companies actively managing funds in the China market today, the market is still dominated by the ten fund companies founded in 1998/99, which together account for over 50 per cent of the total assets under management (AUM).

Sino-foreign joint ventures (JVs) continue to increase their representative market share from zero at the beginning of 2003 to 18 per cent at the end of 2004. As more JVs receive approval from the CSRC to set up operations and launch funds, it is expected that their share of the total market will continue to rise at the expense of other fund managers, large and small.

Product segmentation

The types of funds available to investors in the China market, are limited despite the various creative fund names that may suggest otherwise. There are officially six types of funds available: money market, fixed income, closed-end, equity, balanced and guaranteed. In reality,

however, there are only four types: money market, fixed income, balanced and guaranteed. All existing closed-end and equity funds should have an asset mix rather similar to balanced funds given the previous regulations that required all products to maintain at least 20 per cent of total assets in government bonds. This has changed as of 1st July, 2004 with the CSRC's issuance of Measures for Management of Investment Funds, which eliminated the requirement for funds to have 20 per cent of total assets allocated to government bonds.⁴ This means that overall approximately 75 per cent of the industry's assets managed are balanced products with little real difference in either the management or allocation of those assets. There are of course the money market funds and guaranteed funds, both low risk low return products, that were introduced last year. Investors in reality have a choice between a balanced fund or one of these low risk alternatives.

The major players have primarily the same product offerings, and new entrants

are taking little or no risk as they come to the market with products similar to those provided by the more established managers. It can therefore be concluded that product differentiation currently is not assisting individual fund managers in differentiating themselves in the market. What fund managers do rely on is branding and strong performance. Product differentiation is only slowly bringing real investment alternatives to the public. Newer products, such as convertible bond funds or small cap funds, will help in speeding up this trend but it is expected to take some time.

Distribution

Currently there are eight banks licensed to undertake custody of investment funds: Bank of Communications, Industrial and Commercial Bank of China, Construction Bank, Agricultural Bank, Bank of China, China Merchants Bank, China Everbright Bank and Shanghai Pudong Development Bank. These custodian banks are the main channel of distribution for funds in China.

In exchange for their custody business, banks will promote a fund manager's new product through their branch network across the country. The problem with this method of distribution has been the high volume of redemptions. In order to provide sufficient support for a new fund, bank agents will advise customers to sell existing funds in their portfolios to raise cash to purchase the new fund. Despite the volatility that this method of distribution causes, fund managers continue to rely on their custodian banks. Retail investors see funds as speculative instruments rather than long-term investments and when the market is robust, they are eager to punt by selling one fund to buy another, despite the fact that the products may be

similar. The IPO of a fund is associated in the minds of investors with the IPO of a company and investors expect a new fund to rise substantially immediately upon listing!

In addition to commercial banks, brokerage houses are another major distributor of retail funds. Recently, a few managers have reported success in direct distribution via their own websites as well.

For institutional funds sales of funds, for example to insurance companies or other corporate clients, the fund managers normally rely on their own sales teams. But even with institutional clients, if the fund is bought as a 'favour' to the fund manager, it may only be held for six months before being sold.

Competition with insurance AMCs and banks

In response to demand from the insurance industry, effective 1st June, 2004, insurance companies are able to convert their investment departments to investment management subsidiary companies according to the interim provisions on the Regulations of Insurance Asset Management Companies issued by the China Insurance Regulatory Commission (CIRC).

The business scope of insurance asset management companies (AMCs) is currently restricted to managing funds from its shareholders and other business as approved by the CIRC. This restriction effectively limits the scope of business to managing internal insurance funds and therefore limits the competition insurance AMCs will pose to fund management companies who are permitted to manage funds which can be bought by both retail investors and by insurance companies. Where insurance AMCs will pose direct competition for the CSRC approved fund managers is in

the Pillar II enterprise annuity business which is open to insurance AMC's and fund management companies, as well as asset management subsidiaries of trust companies and securities companies.

Furthermore, the China Banking Regulatory Commission (CBRC)⁵ has issued guidelines in February 2005 for commercial banks to set up fund management companies as well. Given the distribution power of the commercial banks, their presence in the sector will put considerable pressure on existing players.

Foreign JVs

Since China's accession into World Trade Organization (WTO) in December 2001, foreign fund managers have been permitted to access China's fund management industry through JVs. The attraction for the Chinese side is access to foreign expertise in fund management, financial control, risk management and IT platforms. For the foreign side the benefits are access to distribution channels, a large client base and a network of local partners. Foreign parties are also expected to bring in creative ideas for new fund products. Best corporate practices should also be introduced by the foreign partner through such a JV, in addition to capital and brand names. At a later stage, when regulations permit, the Chinese side would look to the foreign partner for management of non-Chinese, ie, international funds.

JV regulations

Joint ventures are formed based on the Rules for The Establishment of Fund Management Companies with Foreign Investment issued by the CSRC on 1 June 2002. The Rules require that a foreign investor wishing to establish a JV

must have paid-up capital of not less than Rmb300m (\$36m). In addition, the foreign investor must be a financial institution established in accordance with the laws and regulations of the jurisdiction where it is domiciled, not have any record of violations of the law in the preceding three years, and be established in a jurisdiction with a recognised securities regulatory regime and whose securities regulatory body has entered into a cooperative arrangement through a memorandum of understanding with the CSRC in respect of securities regulation.⁶

Foreign investors who meet the qualifying criteria in these Rules may either:

- (a) invest in an existing domestic fund management company by purchasing shares from an existing shareholder of that domestic fund management company, or subscribing for new shares of that domestic fund management company as a new shareholder; or
- (b) it may jointly with one or more domestic companies establish a new fund management company.

The domestic shareholders of a JV must meet the eligibility criteria set by the CSRC for fund management companies. This means that the major shareholder must be a Chinese securities company or trust and investment company, but other shareholders can be non-financial institutions from any industry as long as they have a clean reputation.

Since December 2001, foreign parties have been able to own 33 per cent of the equity in joint ventures, and this will be raised to 49 per cent in December 2004. The Rules do not limit the number of fund management companies that a foreign investor may invest in but the CSRC has stated that for the time being,

it would encourage domestic and foreign shareholders of JV fund management companies to invest in no more than two fund management companies, of which any shareholder shall not take a controlling stake in more than one.⁶

Green field or acquisition

In the initial stage of foreign companies attempting to enter China's fund management market, it was assumed that the ideal partner would be an existing fund management company (FMC), as this path of entry would be the safest and easiest. The foreign partner could avoid being entangled with the regulatory bureaucracy of setting up a new operation, establishing a distribution network and building up a market reputation. But the well publicised process of long, costly yet unsuccessful negotiations confirmed what sceptics anticipated, that agreeing on a fair purchase price and allocation of management control, and concluding the due diligence with confidence that the target FMC is of acceptable professional and ethical standards would not be easy and would lead to a breakdown of negotiations.

As at the end of 2004, there were 13 approved joint venture fund management companies in China, 11 of which have already launched their first funds. With a few exceptions of JVs formed with trust and investment companies, most foreign companies have chosen to form partnerships with Chinese securities firms to build a new fund management company rather than buying into an existing one. The major advantages of this approach are that there is no need to conduct due diligence and there is no need to value an existing business or to negotiate a fair share price. The ownership structures of approved JVs are listed in Table 2.

Fund managers' roles in pensions

There are five types of pension assets in China's pension system that fund managers can potentially manage:

- (a) Pillar Ia social pool contributions made by employers;
- (b) Pillar Ib individual account contributions made by employees and employers;
- (b) Pillar II supplementary pensions — enterprise annuities;
- (b) Pillar III other supplementary pensions;
- (b) National Social Security Fund.

Pillar Ia is essentially operating on a pay-as-you go basis and any funds are tightly held by the provincial social security bureaus. So in effect, there are really four possibilities for fund managers.

Currently, ten fund management companies are managing a portion of NSSF funds. Many companies will seek approval to enter the Pillar II enterprise annuities market. As for Pillar Ib assets, they are still officially managed by local social insurance bureaus.

Ten AMCs involved in NSSF asset management

In 2002, the National Council for Social Security Fund (NCSSF) which administers the NSSF announced its intention to outsource funds to qualified asset managers. One of the qualifying criteria was that the asset manager must have at least two years of operating history in China, limiting the number of qualified applicants at that point. Ultimately, of the ten applicants, the six selected were: Boshi, Changsheng, China Asset, Harvest, Penghua and Southern Fund Management. In 2004, the NCSSF carried out another search which resulted in four more managers being selected,

Table 2: JVs approved for operations and with first fund launched as at end of 2004

Company name	International partner		Local partner	
1. GTJA Allianz fund management	Allianz Dresdner	33%	Guotai Junan Securities	67%
2. Fortune SGAM fund management	SG Asset Management	33%	Huabao Trust	67%
3. China Merchants fund management	ING Investment Management	30%	China Merchants Securities	40%
			China Power Financial Co Ltd	10%
			China Huaneng Financial Co Ltd	10%
			China Shipping Financial Co Ltd	10%
4. ABN AMRO Xiangcai fund management	ABN Amro Asset Management	33%	Xiangcai Securities	37%
			Shandong Xinyuan Co Ltd	30%
5. Fullgoal fund management	Bank of Montreal	16.67%	Haitong Securities Co Ltd	16.67%
			Shenyin & Wanguo Securities Co Ltd.	16.67%
			Huatai Securities Co Ltd.	16.67%
			Fujian International Trust & Investment Company	16.67%
			Shandong International Trust & Investment Company	16.67%
6. Fortis Haitong fund management	Fortis Investment Management	33%	Haitong Securities Co Ltd*	67%
7. Invesco Great Wall fund management	INVESCO Asia	33%	Great Wall Securities Co Ltd	33%
			Kailuan Group Co Ltd	17%
			Dalian Shide Group Co Ltd	17%
8. SYWG BNP Paribas Fund	BNP Paribas	33%	Shenyin & Wangou Securities	67%
9. China International fund management	JP Morgan Chase	33%	Shanghai International Trust and Investment	67%
10. Everbright Pramerica fund management	Prudential Financial, Inc.	33%	Everbright Securities Co Ltd	67%
11. BOC International fund management	Merrill Lynch	16.5%	BOC International Securities Co Ltd	67%
			BOC International Holding Company	16.5%
Approved for operations but yet to launch fund				
1. Franklin Templeton Sealand fund management	Franklin Templeton	33%	Sealand Securities Co Ltd	67%
2. AIG Huatai fund management	AIG	33%	Huatai Securities	67%

Source: Harvest Fund Management Co

including two Sino-foreign JVs: E-Fund, China Merchant (JV), Guotai, and China International Capital Corporation (JV).

Three types of mandates were given to the managers: money market, fixed income and equity. The initial amount outsourced was US\$2bn with each of the six managers receiving up to US\$330m. Although the individual managers' performances have not been disclosed, it is assumed that they were satisfactory as the NSSF has continuously increased the mandates to each of the six managers, bringing the

total amount of outsourced funds to US\$6bn by the end of 2004. It is understood from industry sources that the actual fees charged are approximately 0.5 per cent for equities and 0.25 per cent for fixed income mandates.

In the near future it is hoped that the NSSF will be able to allocate a small proportion of its assets to international investments. The NSSF has also obtained approval for overseas investments (this was granted by the State Council in February 2004) and has engaged Mercer

Table 3: Pension opportunities for fund managers

Type of pension assets	Current manager	Potential for fund management companies
Pillar Ia Social pooling	PAYG	No
Pillar Ib Individual accounts	Local social security bureaus	Yes
Pillar II Enterprise annuity	Fund managers to be licensed	Yes
Pillar III Other supplementary plans	Insurance companies	Asset management subsidiaries of insurance companies
National Social Security Funds	Internal plus six external asset managers	Yes

Investment Consulting to advise on international asset manager selection and international asset allocation.

EAs

China's supplementary pension, EAs, which came into effect on 1st May, 2004 is an area that represents tremendous opportunity for service providers. Fund managers may wish to qualify to provide multiple services to the EA market including asset management, trusteeship and administration. At this point, although it makes strategic sense to be a multi service provider, fund managers are generally hesitant to venture beyond their core business of managing money. The larger fund managers are all understood to be filing their applications with the MOLSS to become provide fund management services. Meanwhile, all potential service providers are keeping a close watch as more detailed regulations unfold. But given the pending decisions from provincial governments on the tax benefits for EA contributions and the uncertainty of the size of the potential market, most providers are cautious. Given the uncertainties, those that have decided to enter the market say that they do not expect the EA business to contribute to profitability as a significant business segment during the initial two years.

Yet, given the potential of the EA market, it is too important for any established fund management company to

ignore. The estimated market potential of 'Rmb100bn per year' (US\$12bn) has often been attributed to the MOLSS. Although potential EA service providers dispute this figure as overly optimistic in the near- or even mid-term, few would argue emphatically that it is not a real possibility in the long term.

Conclusion

There are still issues pending in the pension systems that need to be resolved, but generally, reforms are moving in the right direction. Most importantly, the fundamental structure of the three pillar system that China has adopted diversifies the financial burden as well as the risk of collapse due to mismanagement or budget shortfalls. The pilot programmes in the northeastern provinces and government policy that encourages the development of a private pension pillar are all steps towards ultimately creating a system that provides a redistributive subsistence income to all retirees, a fully funded individual account pension and a possible supplementary account that rewards high savers.

The success of the supplementary accounts will depend largely on the existence of a well established fund management industry. Despite the increasing competition, there is plenty of optimism in the industry from current participants and those who are surveying the market. Foreign institutions' entry into the China market post WTO is

increasing competition and raising standards of operation to international levels in the financial services industry. Local companies are therefore rapidly reinventing themselves in order to compete effectively. These are very positive developments for pension fund management.

There is plenty of room for growth for all players, domestic and international. In addition to the available household savings and developing pensions market, in a fund market that is still dominated by basic products — balanced funds, money market funds, etc — there is also growth potential from introducing new products and new ideas. So while the current market may be dominated by the 'big ten', there is ample room for new or innovative players to enter the market and change the current landscape.

References

- 1 The World Bank has recently issued a policy announcement which recommends the addition of two more pillars to the previous three pillar system. These two new pillars consist of a non-contributory pillar to alleviate poverty and an informal pillar which includes non-financial transfers from family and the community for housing and healthcare.
- 2 Leckie, S. and Zhang, T. (2001) 'Investment Funds in China', Finance Asia, Hong Kong.
- 3 The requirement that all funds must hold at least 20 per cent of net assets in government bonds was eliminated on 1st July, 2004.
- 4 A fund launched before 1st July, 2004 with 20 per cent of total assets allocated to government bonds may apply to the CSRC for permission to become a 100 per cent equity fund.
- 5 CBRC was established in March 2003 to take over responsibility for bank supervisory functions from the People's Bank of China, leaving the central bank to focus on monetary policy. The CBRC is authorised to supervise and regulate banks, trust and investment companies and other deposit-taking institutions.
- 6 Clifford Chance (2004), *Foreign Participation in Sino-Foreign Joint Venture Fund Management Companies in China*, January.