

**CHINA'S PENSION SYSTEM REFORM  
AND CAPITAL MARKET DEVELOPMENT**

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# **China's Pension System Reform and Capital Market Development**

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## Summary

The paper analyzes the interaction between the pension system and capital market development in general, and the case of China in particular. A funded pension system is most likely to boost the capital market, but in the absence of supportive financial infrastructure and effective financial regulation, A funded system will not be successful. China's determination to establish a partial funded system is a first step in the right direction, but without the separation of individual accounts from the social pooling and their replenishment, the workout of the implicit pension debt, and improvements in pension fund management and regulation, the pension system will not be sustainable. As to capital market development, the key is to contract out pension fund management to professional asset managers, to support China's major financial players, and to speed up the financial opening. At this point, investment of pension assets in mutual funds and a pilot program of private-placed, open-end funds can be initiated.

## **Introduction**

There is close relationship between the pension system and the capital market, which is evident in developed countries where pension funds, with large amounts of assets,<sup>1</sup> are the key institutional investors in the capital markets. Although this topic has not yet received much attention, the interaction between pension reform and capital market development may be striking. In recent years we have witnessed the reform of pension systems from pay-as-you-go to funded systems in some Latin American and East European countries, where the retirees' pension benefits come mainly from their individual accounts, not from the contributions of the next generations. As a result, pension assets have increased dramatically, accounting for an increasing percentage of GDP (table 1). Because of the immediate impact of the investment performance of the pension funds on the retirees' pension benefits, many countries are paying close attention to the diversification of pension investments, resulting in the development of domestic capital markets. Part one of this paper presents an outline of the promotional impact of a funded pension system on the capital market by focusing on developing countries that are undergoing pension system reform. Part two analyzes the key factors influencing such an impact. Part three discusses the relationship between China's pension system reform and its capital market development. Policy implications are given in Part four and concluding remarks are presented in Part five.

## **1 The promotional impact of a funded pension system on capital markets**

### **1.1 Increase in national savings and investment**

After the establishment of a funded pension system, social precautionary savings, as well as national savings, will increase substantially. More money will be available for capital market investment. In Chile, the ratio of social precautionary savings to GDP jumped from 1.9 percent in 1984 to 3.8 percent in 1994, and the ratio of national

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<sup>1</sup> In 1987 the total assets of pension funds accounted for 29 percent of GDP in the OECD countries; in 1996, the ratio reached 38 percent. The annual growth rate of pension fund assets was 10.9 percent during the 1990-1996 period.

savings to GDP increased from 13.6 percent to 26.8 percent (Sanchez 1998). Managed by professional institutions, the precautionary savings are beneficial to the optimization of resource allocation and economic growth. Take venture capital as an example. In 1998, US\$13.3 billion of venture capital came from the investment of pension funds, accounting for 60 percent of the venture capital commitment; in 1997, the ratio was only 33.1 percent. Without a doubt, the pension funds have played a crucial role in the development of hi-tech industries and the so-called “New Economy.” Another convincing example is provided by an econometric study: the blossoming of pension funds in Chile led to a rise of one percentage point in the total factor productivity (TFP) on a yearly basis and the contribution factor of pension funds to TFP was 50 percent (AIYER 1997).

Table 1: Private pension funds in Latin American countries

	Total assets (million US\$)			Percentage of GDP(%)		
	1998	2005*	2015*	1998	2005*	2015*
<b>Argentina</b>	11526	57638	181942	3.5	12.8	26.1
<b>Bolivia</b>	367	4215	8538	4.1	32.0	41.8
<b>Brazil</b>	78308	104583	279541	9.5	15.3	26.4
<b>Chile</b>	31366	60127	126345	39.7	49.0	54.8
<b>Colombia</b>	1950	13961	58080	2.1	11.2	30.0
<b>Mexico</b>	9256	53106	165001	2.7	12.4	28.6
<b>Peru</b>	1723	8005	25302	2.5	8.9	18.9
<b>Uruguay</b>	361	1646	4200	1.3	4.5	7.8
<b>Total amount/Average</b>	135471	303172	848949	7.6	15.5	28.6

\* Estimate

Source □ Salomon Smith Barney

## 1.2 Enhancement of financial competition and financial deepening

The growth of pension funds represents a challenge to the dominant position of commercial banking and is beneficial to the expansion of financial markets, and hence, their liquidity and efficiency. A case in point is the case of Chile in 1984 when the stock

and bond markets were virtually negligible and in 1997, when the capitalization of these two markets were US\$7 billion and US\$80 billion, respectively. At the end of 1998, 63 percent of government bonds, 54 percent of mortgage bills and banking notes, 16 percent of bank deposits, and 10 percent of stocks were all held by pension funds.

### **1.3 Acceleration of financial innovation**

The development of mortgage bonds, corporation bonds, and public agency bond markets in both Chile and Argentina has been largely attributed to pension system reforms. Recently, the emergence and growth of venture capital and infrastructure funds in these countries have attracted more and more pension investment. Furthermore, pension investment has been the driving force behind the evolution of financial derivatives. In Germany, pension funds are allowed to make alternative investments for the purpose of arbitrage. Such investments are limited to 10 percent of the total pension assets in Hong Kong and they are much more pervasive in the United States

### **1. 4 Reinforcement of financial regulation, resulting in better protection of investors**

The safety and profitability of pension funds are critical to the pensioners' benefits and social stability, thus posing increasing demands for sound financial regulation. Several years ago, in Chile, Argentina, and other countries where the pension systems were being overhauled, concrete steps were taken to strengthen information disclosure, fiduciary duty and a crackdown on insider trading, and out-of-line self dealing so as to achieve better investor protection. A comprehensive risk evaluation system was established in Chile to compensate for the disadvantages of private risk rating agencies and for the convenience of pension funds to choose appropriate investment instruments.

### **1. 5 Stabilization of the securities markets and modernization of trading systems**

Because of their long-term investments and predictable trading styles, pension funds are stabilizing forces in the securities markets. During the 1988-1992 period in Chile, the stock market variation coefficient, the ratio of the variance of monthly average returns of the market index to the monthly average returns, was only 1.92, far lower than that of Mexico (2.44), Argentina (3.25), Peru (3.73), and Brazil (4.46), where

pension markets were not yet flourishing (Sanchez 1998). Moreover, The large scale investments of pension funds in securities markets resulted in substantial improvement in the market infrastructure in terms of a central depository agency, settlement and clearance system, bookkeeping system, etc, which led to a reduction in the market transaction costs and a boosting of market liquidity and transparency. For instance, the Chilean electronic securities market that was established in 1989 reduced bond trading costs from 0.015 percent in 1985 to almost zero at present.

### **1.6 An increasingly important role played by pension funds in corporate governance**

As long-term investors and shareholders, pension funds pay close attention to the management of invested companies. In the United States, public pension funds are more active in corporate governance. The California State Public Employee Retirement System (CalPERS) once put forward a package of proposals to resolve some critical problems in corporate governance. The pension funds collaborate with one another to exclude unqualified management, and to protect shareholders' interests in M&A and other major events. Some giants in corporate America, including American Express, General Motors, IBM, and so on, have had to change their senior management under pressure from the pension funds or other institutional investors. The growing role played by pension funds in corporate governance may be a big plus in the improvement of listed companies and the healthy development of a securities market.

## **2 Key factors influencing the effects of a funded pension system on capital markets**

### **2.1 The institutional design of the pension system**

Although pension reform has been a global trend, various factors have different effects on capital markets.<sup>2</sup> First, with respect to the importance of PAYG basic pension plans

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<sup>2</sup> According to statistics, the pension systems in 82 countries have been undergoing adjustment and restructuring in recent years; 21 countries of which have initiated large-scale structural reform. The reform of defined-benefit, PAYG pension system may lead to three different systems: the first is the defined contribution and fully funded system with individual accounts after resolving the implicit pension debt (e.g., Chile, Argentina, Bolivia, Colombia, Mexico, Peru, Hungary, and Kazakhstan) ; the second is the notional defined contribution system without cleaning the huge amount of pension

in the whole pension system: The dominance of basic pension plans with very high replacement rates in the whole pension system means that there is less room for funded pension plans and more gloomy prospects for capital market development, due to the much smaller asset accumulation for long-term investment and ineffective fund management by government agencies. As a result, the investment instruments are limited to government bonds and bank deposits. Second, with respect to mandatory contributions or voluntary contributions to individual accounts: Mandatory contributions allow for the rapid accumulation of pension assets that then may be invested in the capital market. The private pension plan in Argentina was initiated one-half year later than that in Hungary, but the ratio of pension assets to GDP was 1 percent, as opposed to the 0.1 percent in Hungary, due to the mandatory contributions. Third, with respect to defined-benefit or defined-contribution Schemes: Normally the retirement benefits from defined contribution plans are uncertain, depending to a great extent on the state of the capital market and the investment returns of the pension funds. The U.S. 401(K) plans and Chile's private plans, typical DC plans, are playing a crucial role in the development of their respective domestic securities markets. Fourth, the market structure of the pension funds is also very important. If the pension funds are too dispersed and hence lack of economics of scale, resulting from poor long-term programming, it is difficult for them to diversify their assets, not to mention to become strong institutional investors in the capital markets. There were 179 pension funds, for example, in Hungary at the end of 1995, averaging merely US\$0.3 million in assets per fund.

## **2.2 Domestic capital market infrastructure**

A funded pension system requires such preconditions as market stability, sound commercial banking and commercial insurance systems, and effective financial regulation, etc. (Vittas 1998). Without such preconditions, it would be hard to imagine a deepening of the pension reform. Even though the capital market may have reached a

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liabilities (e.g., Poland, Latvia, and Sweden)□the third is occupational defined contribution pension schemes (e.g., Switzerland, Australia, and Denmark). It is noteworthy that the opposite strategies have been taken in Singapore and Malaysia, where the defined contribution Provident Fund systems

certain scale at an early stage of the pension system reform, without a reasonable structure, the promotional effect is still insufficient, indicating evidence of path dependence. For instance, in some continental European countries, such as Switzerland, where the stock markets are relatively underdeveloped, the investments of the pension funds mainly flow to bonds and other fixed income financial instruments, and have little impact on the development of domestic stock markets. In another example, 33 percent of the Irish pension funds, the highest level in the industrial countries, are invested in international stock markets because of the over-concentration of the domestic market, with the largest five stocks taking up close to 80 percent of the Irish share of the weighting in the MSCI EAFE Index (Gorman 1998).

### **2.3 Government intervention in pension fund management**

First of all, the purpose of fund management may be diverted due to government policy. The fundamental objective of fund management is to provide maximum long-term returns to employees and their families, given an acceptable risk level. The absolutely clear stipulation of this point in legislation in California facilitates the sufficient use of capital markets by pension funds to achieve the highest returns. But in some countries pension funds are accepted as special instruments of the government to achieve certain policy objectives. Until very recently, more than 90 percent of the provident funds in Singapore and Malaysia could only be invested in non-tradable government securities, mortgage credit agency bonds, and so on, whose interest rates were several percentage points lower than the market rates. Over the past two years, over 3.7 billion ringgit, roughly US\$1 billion, from the Malaysian provident fund was spent to support state-sponsored programs, including airport construction, state-owned enterprise subsidies, and the bailing out of near bankrupt financial institutions (Lopez 1999). It is obvious that the provident fund pool has been used for general purposes under government direction, having little impact on domestic stock market development.

### **2.4 The regulation style of pension funds**

Due to the underdevelopment of the capital market, it is quite understandable that

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are being transformed into PAYG (Schwarz 1999).

developing countries implement strict draconian regulations at the beginning of their pension system reforms. But as the capital market matures, if the restrictions have not been relaxed or lifted on a timely basis, they may become a “bottleneck” inhibiting further development of the capital markets. The restrictions and their potential damages may be illustrated by several points. (1) The stipulation that all pension funds can only be managed by specific pension fund management companies rules out business opportunities for insurance companies, mutual fund management companies, and so on. The immediate results of such restraints are the lack of competition in pension fund management and, as a result, higher costs and lower profitability.<sup>3</sup> (2) The rigid restrictions on the pension funds’ portfolios, especially their investments in stocks, financial derivatives, and foreign securities, may suppress the development of these markets. (3) The mandate that pension fund management companies should achieve a certain level of investment return can easily lead to passivity on the part of the fund management companies and to the convergence of management styles, which is not helpful in fulfilling the pensioners' different needs.

## **2.5 Fund management competition**

In Chile, most of the pension funds are privately-managed, characterized by "one person an account," and "one company a fund," meaning that if the employees are not satisfied, they are able to transfer their individual accounts to other pension funds. The resultant fund management competition leads to better service and more prudent management. In Mexico, in order to prevent a monopoly, the government mandates that the pension assets managed by a fund management company cannot exceed 20 percent of the total pension assets in the country. In sharp contrast, government agencies that manage pension funds may not be so active in pursuing higher returns for the pensioners because market competition is not a serious concern; even worse, they may embezzle funds if a sound monitoring system is not in place.<sup>4</sup> As a matter of fact, the

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<sup>3</sup> Such a management style is most evident in Chile. Although the average investment return rate of pension funds was 12.7 percent over the 1982-1995 period, considering the high start-up costs and sales costs, the internal return rate turned out to be negative during the first four years and merely 0.3 percent over the following five years (Shah 1997).

<sup>4</sup> According to the World Bank, the performance of publicly managed pension funds is relatively

privatization of pension fund management is a worldwide trend. In the United States, for instance, more and more regional public pension funds are managed by private asset management companies (Burton 1999).

### **3 The pension system and capital markets □ the case of China**

Basically, China's mandatory pension scheme is a defined-benefit, pay-as-you-go system for older workers and retirees, while for younger workers it is designed as a multi-pillar system combining social pooling and individual accounts.<sup>5</sup> The system includes a mandatory defined-benefit paid out of the social pooling account, a monthly annuity paid out of the defined-contribution, employee individual account, and a voluntary supplementary individual account. The details of the contributions and designed benefits are illustrated in table 2.

The World Bank estimates that if the new system proceeds smoothly, the total pension assets will reach US\$1.8 trillion in the year 2030, from which the capital market may benefit greatly due to the continuing inflow of capital. However, there are some shortcomings in both the current pension system and the capital market that may impede a positive interaction between the two.

#### **3.1 A partial funded pension system is not yet taking shape.**

At present, the partial funded pension system has not yet evolved and the pension assets available to capital market investment are quite limited, largely due to notional individual accounts and the underdeveloped supplementary corporation pension schemes. Before the reform initiative of 2000, the SOEs had to bear a double burden: contributions to both the social pooling and the individual accounts. In order to reduce the contribution rate of SOEs and to enhance their competitiveness, in most areas the social pooling funds and individual accounts in the basic pension schemes are not

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poor. From 1980 to 1990 □ the average investment return rates of publicly managed pension funds in Egypt, Zambia, and so on were lower than □ 10 percent, while over the same period, the profitability of private pension funds in the UK, the U.S., and the Netherlands were 8.8 percent, 8.0 percent, and 6.7 percent, respectively.

<sup>5</sup> "Decision to develop a unified basic old-age pension system for enterprise employees," State Council Document No. 26, 1997.

completely separated; rather they are mixed together, that is, the money in the individual accounts can be used to cover the shortfall in the social pooling funds, thus leaving the individual accounts empty. The individual accounts are supposed to be replenished promptly, but the reality is just the opposite: despite 94.7 billion YUAN in the social pooling reserve at the end of 2000, the shortfall in the individual accounts is becoming larger and larger, making the partial funded pension system an illusion. On the other hand, given the rather poor performance of many SOEs and the 83 percent replacement rate of the basic pension schemes, most SOEs have no capacity or incentive to sponsor Enterprise Annuity Plans, the supplementary corporation pension schemes.<sup>6</sup> As a result, only a limited amount of pension assets in the individual accounts are available for capital market investment.

Table 2: Comparison of three pension plans

	<b>Current system in China</b>	<b>Reform Initiative of 1997</b>	<b>Reform Initiative of 2000</b>
<b>Social pooling</b>	<b>Contribution:</b> 23-34% from enterprises <b>Replacement rate:</b> 80% or above <b>Coverage:</b> SOE workers in urban area	<b>Contribution:</b> 17% from enterprises <b>Replacement rate:</b> 20% <b>Coverage:</b> formal sectors	<b>Contribution:</b> 20% from enterprises <b>Replacement rate:</b> 30% <b>Coverage:</b> formal sectors
<b>Mandatory individual accounts</b>	<b>Contribution:</b> 3% from employees (Shanghai and Beijing 5%) <b>Replacement rate:</b> 10%	<b>Contribution:</b> enterprises 3%, employees 8% <b>Replacement rate:</b> 38%	<b>Contribution:</b> employees 8% <b>Replacement rate:</b> about 30%
<b>Voluntary individual accounts (enterprise annuity)</b>		<b>Contribution:</b> enterprises, employees	<b>Contribution:</b> employees; enterprises

Source: World Bank 1997; State Council Document, No.26, 1997; No. 42, 2000.

From the second half of 2001, a pilot program for an urban social security system was

<sup>6</sup> At the end of 2000, 5.6 million workers participated in Enterprise Annuity Schemes, with 19.2 billion yuan of reserves.

implemented in Liaoning province.<sup>7</sup> As to the pension system, compared with the pension reform in 1997, the contributions of the enterprises to the social pooling increased from 17 percent of the employees' payrolls to 20 percent, while the contributions to the individual accounts, now completely the obligation of the employees, fell from 11 percent to 8 percent. Strictly separated from each other, the social pooling and individual accounts constitute the basic pension scheme. A supplementary corporation pension scheme, in the form of individual accounts, is encouraged<sup>8</sup> as well and will be managed in a market-oriented manner.

The most noteworthy aspects of this reform are the consolidation of the social pooling and the separation of the individual accounts from the social pooling, which are essential measures to establish a real partial funded pension system. However, without parametric reform<sup>9</sup> and fundamental changes in pension management and regulation, I believe the system is still unsustainable financially.

### **3.2 Ineffective pension fund management and low returns**

At present, in sharp contrast to international norms, pension fund management and surveillance are combined together, taken by social security agencies at various levels in the administrative regime. The immediate results are weak information disclosure and a lack of monitoring, hence, leading to the embezzlement of pension fund assets. It has been estimated that there were losses of more than 10 billion YUAN, or around US\$1.5 billion at the end of 1997 (Kong Jingyuan 1997). Even though there were no asset misappropriations, given the investment restrictions that the pension funds can only invest in government bonds and bank deposits and the downward trend of interest rates in recent years, the profitability of the pension funds is rather worrisome.

The reform initiative of 2000 is a step in the right direction in the sense that the management of supplementary pension schemes will be based on market principles. However, no concrete measures have followed this initiative. In addition, the

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<sup>7</sup> "The pilot program concerning the improvement of the urban social security system," State Council Document, No. 42, 2000.

<sup>8</sup> It is stipulated that up to a certain level of the enterprises' contributions to the supplementary pension schemes, or 4 percent of the employees' payrolls, can be treated as accounting costs.

<sup>9</sup> Such as lengthening the working period, increasing the contribution rate, and lowering the benefit level, etc.

management of individual accounts in the basic pension scheme remains unchanged, i.e., in the hands of administrative agencies, with their assets only allowed to be invested in government bonds, which is sharply at odds with the trend of investment diversification.

Although there has been no fundamental change in the management regime of the partial funded pension assets, a path-breaking event did take place in September 2000, when the National Council for Social Security Fund (NCSSF) was established. The NCSSF is assigned the task of managing the National Social Security Fund (NSSF), the pool of assets coming from state-owned asset sales, fiscal appropriations, and the issuance of lottery tickets, etc. In principle, the NCSSF will not be involved in the direct investment management of the NSSF, but will delegate management to qualified asset managers. I believe such a model will have strong implications for the management of the pension assets in the individual accounts.

### **3.3 Lack of appropriate institutions for pension management and services**

Until now, there are no professional, market-oriented pension fund management institutions in China. The potential important players in pension management, such as commercial insurance companies and mutual fund management companies, are still afflicted with problems that cannot be neglected.<sup>10</sup>

The key problems in commercial companies are as follows. (1) They are rather small and lack economies of scale, compared with their international competitors. The operation of commercial companies is based on the law of large numbers: the larger the scale, the easier for them to diversify the risks and to make profits. (2) Their capital bases are very weak. It has been estimated that the shortage of capital in China's insurance companies will reach US\$12 billion or more in the next five years (Ma

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<sup>10</sup> On the one hand, insurance companies can sponsor pension plans and act as trustees, custodians, and/or fund managers, just like the case of Mandatory Provident Fund in Hong Kong. On the other hand, pension funds invest heavily in disability insurance and survivorship insurance; after retirement, the pensioners often purchase life annuity. In some countries that are undertaking a three-pillar pension reform, the third pillar—the individual depository pension scheme—is managed by the insurance companies. In addition, the basic pension scheme and supplementary corporation pension scheme also require the involvement of insurance companies. As to the mutual fund management companies, they are capable of accumulation, provision, and transfer of pension assets and are fully qualified for pension fund management.

Mingzhe 1999). As business expands, the capital shortage will become more serious. (3) The commercial companies lack asset management capacities. Given the limitation over past several years that insurance funds can only be invested in government bonds and bank deposits, it had not been necessary for insurance companies to have their own investment management teams. Despite the relaxation at the end of 1999 when insurance funds were allowed to enter stock markets by purchasing mutual funds, generally speaking, the investment venues of insurance companies are still very limited and the fostering of a qualified asset management team will take some time.

With regard to mutual funds, China has 33 close-end funds operated by 14 fund management companies worth about 10 billion yuan. The performance of the mutual funds has not been as good as expected: in the first half of 2001, only 5 of them outperformed the stock markets; even worse, 13 funds had negative returns. There are several key problems in the mutual fund industry: (1) Conflict of interest, manifested by insider trading of fund managers, and the manipulation of their controlling shareholders, mainly securities firms. For instance, the fund assets are used to purchase shares underwritten by the controlling shareholders, and to buy and sell stocks together with the controlling shareholders, etc. (2) The manipulation by the fund managers of the stock market with other financial institutions, resulting not only from poor securities regulation, but also the nature of the stock market. As the stock market is extremely speculative and risky, the long-term perspectives of fund management have to give way to short-term profits; otherwise, the high level of cash distribution required by the mutual fund investors cannot be met. (3) The lack of stock market index futures and other instruments that can be used for arbitrage by fund management companies in periods of a market downturn. (4) A serious shortcoming exists in the institutional design of the contractual mutual funds, namely the lack of a distinction between the custodian and trustee of the fund, resulting in the absence of a trustee and, therefore, weak protection to the investors (Chen Ru 2000).

### **3.4 The poor situation in the securities markets**

China's stock markets are plagued with long-lasting problems of large fluctuations and

very weak investor protection, resulting from pervasive speculation, the low quality of listed companies, poor risk control in securities firms, and loose financial regulation. In addition, the corporation bond market is too small to provide sufficient investment instruments.

#### **4. Pension system reform and capital market development: China's realistic choices**

##### **4.1 Deepening the pension system reform**

Given the unsustainability of the current system and the incomplete reform initiatives, a three-pillar pension system should be established in China, with a defined-benefit basic pension scheme as the first pillar, a supplementary corporation pension scheme as the second pillar, and an individual depository pension scheme as the third pillar.

Among the three pillars, the second, i.e., a supplementary corporation pension scheme, should play the most important role. Some people are skeptical about the feasibility of such a system, arguing that without a developed securities market in place, it is too early to talk about a three-pillar pension system. This pessimism is actually unfounded in the long run for several reasons. First, since asset accumulation in pension funds takes some time, only a very small amount of pension assets can initially be invested in the securities market. The government still has time to standardize and develop the securities market, presupposing a firm commitment and the right strategy. For instance, before Chile's pension system reform in 1980, the total assets of the institutional investors, including those of the pension funds, accounted for less than 1 percent of GDP. By 1995, however, the ratio had risen dramatically to around 60 percent. Second, the investment restrictions can be relaxed step by step in light of the situation in the securities market. At present, the draconian regulations can be justified. Third, at the early stage of the pension system reform, the badly needed fund management experts and skills can be imported from abroad by establishing joint venture asset management firms; this is likely to take place after China's impending accession into the WTO. According to the WTO agreement, upon entry, the share of foreign partners in joint venture asset management firms can be up to 33 percent and can reach 49 percent

within three years.

The keys to establishing a three-pillar pension system include a reduction in the extremely high replacement rate of the social pooling, the development of supplementary corporation pension schemes, and mandatory contributions by enterprises and individuals. The most urgent step, as indicated by State Council Document No. 42 of 2000, is to separate the individual accounts from the social pooling, and to go even further by bringing them into the supplementary corporation pension schemes (Song Xiaowu et al 2000).

#### **4.2 Replenishment of the pension fund to make the individual accounts REAL**

Without the pre-funding of the implicit pension debt (IPD),<sup>11</sup> i.e., collecting money to honor the government's pension liabilities, it is impossible to establish a sustainable pension system, let alone to boost the capital market, regardless of the blueprint for pension reform. Other than the widely discussed proposals, such as the issuance of recognition bonds and lottery tickets, the adjustment of the budgetary expenditure structure, etc., state-owned asset sales is extremely important. There are several potential ways to sell the state-owned assets: (1) An initial public offering. Before the State Council's promulgation of the Provisional Rules for Accumulating A Social Security Fund by State-owned Shares Reduction (State Council Document No.22, 2001) in June 2001, there were random experiments among the listed companies regarding the pension payment by listing proceeds.<sup>12</sup> Aware that such actions would dampen investment interest, many firms declined to disclose related information, which had negative effects on the securities markets. After implementation of Document No. 22, upon a joint stock company's IPO or new shares issuance thereafter, 10 percent of the state-owned shares in that company must be floated. All of the proceeds from the state-owned shares sales are earmarked for the National Social Security Fund. In July,

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<sup>11</sup> The World Bank (1996) estimated China's IPD to be roughly 46 to 69 percent of GDP in 1994. The recent actuarial result of IPD, given by the task force of the State Council Office for Restructuring the Economic System, is much higher--145.4 percent of GDP in 1997 (Song Xiaowu et al. 2000).

<sup>12</sup> Recently, China National Offshore Oil Corp., one of the largest oil companies in China, used \$200m of IPO proceeds for 7,000 retirees who had retired under a corporate reorganization before the company went public.

the first four listed companies sold state-owned assets in this way, collecting 3.4 billion yuan. In the near future, this will represent the mainstream measure for state-owned asset reduction and replenishment of the pension fund. Although this may be sufficient to cover the gap between contributions and pension payments in an individual year, it is far cry from enough to solve the problem of the implicit pension debt.<sup>13</sup> (2) State-owned share sales of listed companies. At the end of 2000, 58 percent of the listed companies' shares were state-owned, which were nontransferable in the stock market. According to State Council Document No.22 of 2001, a very limited number of the state-owned shares of listed companies may be transferred to other shareholders in the same companies or may be repurchased by the company. The scale and timing is to be decided by the authorities, depending on the situation in the stock markets. Until now, no systematic strategy is available in this regard, due to its potential destructive effect on the stock markets. In my opinion, however, this is one of the most promising ways to tackle the implicit pension debt. It may be feasible that part of the state-owned shares of listed companies be allocated right away to the Social Security Fund at no cost, while their floatation can be executed gradually (Fan Gang 2000). (3) SOE asset sales to listed companies. A listed company acquires part of the stakes in a SOE, normally its parent company and the controlling shareholder, with the proceeds from the share floatation. The earnings from the SOE asset sales are turned over to the Ministry of Finance, and then to the National Council for Social Security Fund. (4) private sales to strategic investors. This cannot be carried out on a large scale because of difficulties in precise asset valuation, and, more importantly, concerns about losses of state-owned assets, a serious political issue in China today.

In short, no matter what measure is taken, it should be implemented in a transparent manner and be fully in compliance with the law. Otherwise, investors, especially uninformed small investors, are likely to suffer great losses and ultimately to turn their backs on the securities market.

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<sup>13</sup> In the year 2000, the listed companies raised 210.2 billion yuan by floating shares in the domestic and international markets. Given the 10 percent quota and other things being equal, it is safe to estimate that approximately 20 billion yuan per annum can be collected for the Social Security Fund in this way.

### **4.3 Improvement in pension management and regulation**

First, the fundamental objective of pension fund management should be made clear by legislation, namely to maximize the welfare of the pensioners by professional management and to avoid administrative intervention. Second, a sound fund management structure should be set up. Although the basic pension schemes are publicly managed, they should also be managed in a professional manner. Even though the management of individual accounts in the basic pension scheme is not yet on the radar screen due to their notional state, after the replenishment this issue will not be far away on the horizon. As the National Council for Social Security Fund builds up its management capacities, it is reasonable that in the near future it will be assigned the task of individual account management. At the early stage, it may be justified for the NCSSF to contract out external portfolio management on a competitive and transparent basis, as opposed to the delegation of investment manager choice to individual enterprises or employees. The administrative costs will be much lower under such a relatively centralized management regime. As to the pension fund managers, I do not think it is necessary to set up specific institutions for pension fund management. The bottom lines are sufficient market competition, rigorous regulation, and the resultant sound internal risk control systems of fund managers. If they are qualified, the insurance companies and the mutual fund management companies should be allowed to bid for licenses to manage the pension assets accumulated in the individual accounts. Third, after the development of supplementary corporation pension schemes, as well as the securities market, corporation pension management committees, including representatives of management, trade unions, and social intermediaries, may be responsible for the delegation and surveillance of fund management by themselves. Fourth, by nurturing market intermediaries, including actuary, accounting, auditing, and risk rating agencies, the operation of the pension funds can be monitored more effectively. The intermediaries should accelerate the process of market-oriented reorganization by breaking away from the administrative agencies so as to eliminate intervention and to improve services in the market competition.

### **4.4 Relaxing pension fund investment and allowing a certain percentage of**

### **pension funds to be invested in mutual funds**

At present, a certain percentage of commercial insurance funds is allowed to be invested in mutual funds and their performance has been rather satisfactory. The pension funds can follow suit, with a cap, say, of 10 to 15 percent, to control the risks. In addition, a pilot program of private-placed, open-end funds that are specifically directed against pension funds can be carried out at this stage. The pros of such mutual funds include easy purchase and redemption of the shares,<sup>14</sup> simple implementation of private placement, low sales costs, and convenient surveillance by pension funds. For the purpose of encouraging competition, 2-3 open-end funds can be launched. As the capital market continues to flourish, the restrictions should be eased step by step.

### **4.5 Further development of commercial insurance and mutual fund industries**

For insurance companies, several things need to be placed at the top of the agenda: (1) To strengthen their capital bases by listing domestically or internationally, so that they are more capable of withstanding the risks. Given the insurance companies' pressing demand for capital and the long process before listing in the domestic stock markets, international listing may be considered to be a more realistic alternative. (2) To allow insurance companies to invest in a wide range of financial instruments and to build up their own asset management teams. Under the Principle of Business Separation and international practice, a pilot program can be carried out whereby an insurance company and an asset management company are set up separately under a single holding company. (3) To encourage insurance companies to expand by M&A on a market-oriented basis so that their competitiveness is quickly increased.

For mutual funds, it is essential to launch more financial instruments, including stock market index futures, for the purpose of risk arbitrage. The mutual fund management fees, which are relatively high compared with international standards, should be lowered even further, together with the expansion of individual mutual fund scale. Last but not least, the oversight of the mutual fund management companies should be

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<sup>14</sup> In order to alleviate investor redemption pressures, some measures may be initially taken, for instance, no redemption is allowed within given period of time; only some percentage of the shares are available for redemption; the longer the investment frame, the lower the fund fees; and so on.

strengthened by revising related out-of-date legislation and cracking down on the wrongdoings of the management companies, as well as their controlling shareholders.

#### **4.6 Making full use of international capital and experience**

In order to attract the desperately needed management skills and capital, the financial opening and cooperation related to pension funds, mutual funds, and commercial companies should be accelerated. Given the fact that some of the joint venture financial companies have not been successful because some of the Chinese partners are industrial companies and they lack essential financial talent, only established financial companies in China should be allowed to form financial JVs, for the purpose of absorbing advanced managerial expertise and protecting our own interests.

### **5 Concluding Remarks**

The pension system and capital market development are so closely connected that it is hard to answer the question: which comes first? On the one hand, international experience shows that a funded pension system has profound impact on the capital market. On the other hand, without a supportive financial infrastructure and sound financial regulation, a funded system on its own cannot go too far. At present, both China's pension system and capital market are undergoing massive restructuring and the virtuous interaction between the two has not yet been formed. The keys to the designated partial funded pension system are the separation of individual accounts from the social pooling, the replenishment of individual accounts, and the pre-funding of the implicit pension debt by various means, among which the sale of state-owned assets is the most promising. As a medium- to long-term goal, a three-pillar system should be established, in which the supplementary corporation pension schemes play the most important role. Investment management of the pension assets in the Social Security Fund and the individual accounts should be delegated to professional asset managers and such delegation should be executed in a transparent and competitive manner. As to the capital market, it is most urgent that the major players be fostered, such as mutual funds and commercial insurance companies, to accelerate the financial opening, and to improve financial legislation and regulation.

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