Recent Moves by China's Social Security Fund, an Increasingly Important Participant in Chinese and Global Capital Markets

Eiichi Sekine

I. What is the National Social Security Fund?[1]

The Chinese government initiated broad reforms of its pension system in the 1990s, introducing individual accounts within the basic pension system[2] and new asset-building, defined contribution schemes for corporate pensions. In addition, while reforming the pension system in the direction of such self-help efforts, the Chinese government addressed the shortfall in funding of future benefits for social insurance programs (including the basic pension system) in August 2000 by establishing the NSSF as a safety net.

Established simultaneously with the NSSF to actually manage the funds was the National Council for Social Security Fund ("the Council") (Figure 1). The Council, which reports directly to the State Council (the government's cabinet) and has the same status as other ministries, has a chairman, three vice chairmen, and 13 directors, for a total of 17 members. There are eight permanent committees (departments) that report to the Chairman: General Office, Finance & Accounting, Legal & Compliance, Investment, Equity Management, Information & Research, Human Resources and Administrative Service Center. There are also three non-permanent committees: Expert Appraisal, Investment, and Risk Management.

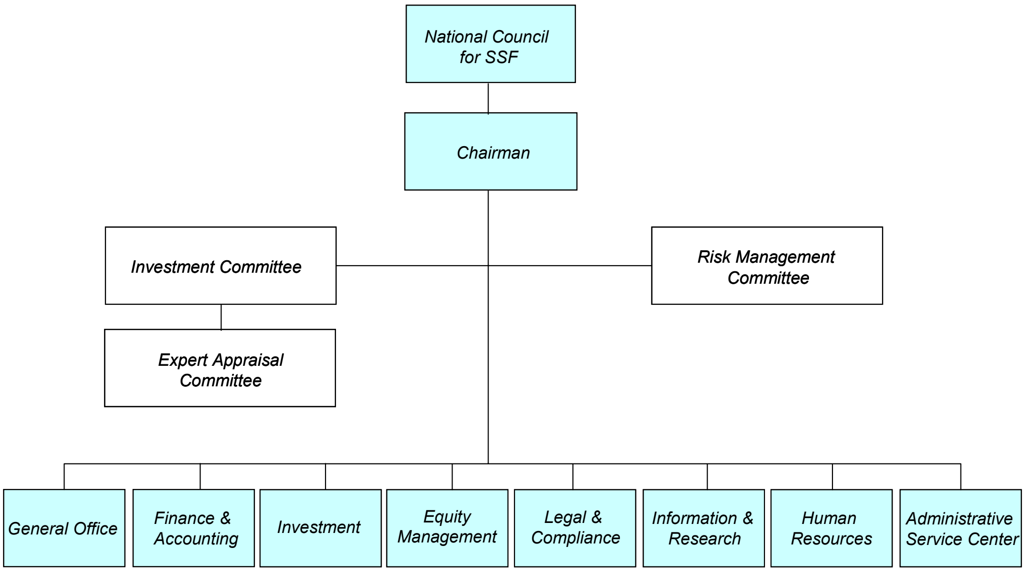
The NSSF is fund by both central government allocations and investment proceeds. It makes investments both on its own and through investment management firms, and in addition to domestic investments began investing overseas in 2006, as explained below. Currently, investments are being added to the NSSF but there are no funds being paid out.

---

1 For an overview of the NSSF, see Chapter 7 (Institutional Investors) of the 2007 *Chuugoku Shoukenshijou Handobukku* (China Securities Market Handbook) from the Nomura Institute of Capital Market Research (in Japanese).

2 Equivalent to the basic pension and Employee's Pension Insurance in Japan.

Figure 1: Management structure for the NSSF



Source: Nomura Institute of Capital Markets Research, based on materials from the NSSF.

II. Key points from the 2006 annual report

On the last day of its meeting on 12 April 2007, the Council announced its 2006 annual report and released an overview of its 2007 investment plan. We begin by summarizing the key points of the 2006 annual report.

1. Expansion of funding sources

At end-2006, the NSSF had total assets of RMB 282.8 billion (approximately ¥4.38 trillion;[3] a year-on-year increase of RMB 71 billion), and total equity (fixed assets less liabilities)[4] of RMB 272.4 billion (approximately ¥4.22 trillion;, a year-on-year increase of RMB 77 billion) (Figure 2).

The RMB 77 billion year-on-year increase in NSSF equity came from a government allotment of RMB 58.1 billion, realized return of RMB 19.6 billion, and a decline in equity of RMB 700 million related to the stock listings of state-owned commercial banks.

This RMB 58.1 billion budget allotment from the government (up RMB 35.2 billion from 2005) comprised RMB 10 billion in a central government budget allotment, RMB 40.7 billion in proceeds from the sale of state-owned shares, and RMB 7.4 billion in national lottery profits (Figure 3).

3 This and all yen-yuan conversions in this report use the mid-rate announced by the State Administration of Foreign Exchange (SAFE) on 30 April 2007 of ¥100=RMB 6.4441 (RMB 1 = ¥15.51).

4 Excluding liabilities in the RMB 5.8 billion pension fund of the government's Operations Department, which handles investments for the NSSF, and in the RMB 4.6 billion of individual accounts in the basic pension system.

2. Allocation of investment assets

Investment assets were allocated into three new categories in 2006: overseas investments,[5] investments managed through individual accounts in the basic pension system,[6] and investments in the Bohai Industrial Development Fund.[7]

Figure 2: NSSF assets

(Units: RMB billions)

Fiscal year	2000	2001	2002	2003	2004	2005	2006
Total assets	20.0	80.5	124.2	132.5	171.1	211.8	282.8
Fund equity	20.0	80.5	124.2	132.5	166.0	195.4	272.4

Note: Fund equity = Total assets minus liabilities
Source: Nomura Institute of Capital Markets Research, based on materials from the NSSF.

Figure 3: Government subsidies to the NSSF

(Units: RMB billions)

Fiscal year	2000	2001	2002	2003	2004	2005	2006
Total government transfers	20.0	59.5	41.6	4.9	27.9	22.9	58.1
Central government budget allotment	20.0	47.3	30.4	0.0	17.1	10.0	10.0
Income from sale of state-owned shares		12.2	8.8	0.4	4.7	8.3	40.7
National lottery profits			2.4	4.5	6.1	4.6	7.4

Source: Nomura Institute of Capital Markets Research, based on materials from the NSSF.

5 The global custodians were selected on 9 October 2006, and the overseas investment managers were selected on 29 November 2006, with well-known financial institutions and fund management companies based in Europe and the US named for both roles.

6 In December 2006, the NSSF took over the investment management of central government allocations to the individual accounts within the basic pension system for nine local governments, including the City of Tianjin. The investment management agreement includes a guaranteed annual return of 3.5%.

7 This is a yuan-denominated investment fund established by the government aimed at industrial development of the City of Tianjin and other areas surrounding the Bo Hai Bay. The NSSF contributed RMB 1 billion out of a total of RMB 20 billion in funds.

On a book value basis, managed assets at end-2006 included deposits, government bonds, and financial bonds of RMB 150.1 billion (53.08%), corporate bonds of RMB 19.5 billion (6.88%), corporate stocks of RMB 68.3 billion (24.16%), stock in non-listed companies and other equity investments of RMB 34.1 billion (12.07%), and securitized products of RMB 1.6 billion (0.57%).

Based on market value, the NSSF had total assets at end-2006 of RMB 326.8 billion (approximately ¥5.06 trillion), including fixed-income products of RMB 149.9 billion (45.86%), corporate stocks of RMB 111.9 billion (34.24%), stock in non-listed companies and other equity investments of RMB 34.1 billion (10.45%), and cash and cash equivalents of RMB 30.9 billion (9.45%). The assets allocations called for in the 2006 fiscal year plan, however, were 55-60% in fixed income, 25-30% in corporate stocks, 10-15% in stock of non-listed companies and other equity investments, and 0-5% in cash and cash equivalents.

The Council attributed the gap between the planned and actual asset allocations for 2006 to several main reasons. It noted first that the higher allocation to corporate stocks was a result of rising share prices in both domestic and overseas stock markets. Second, it attributed the higher allocation to cash and cash equivalents to (1) a concentration toward the end of the year of receipts from the government's budgetary allotments and of assets managed on behalf of basic pension system individual accounts and (2) an accumulation of funds caused by delays in receiving approvals related to trust investments.

Figure 4: NSSF realized rate of return

Fiscal year	2002	2003	2004	2005	2006
Realized rate of return (%)	2.75	2.71	3.32	3.12	9.34

Note: Realized rate of return = realized income / weighted average assets under management

Source: Nomura Institute of Capital Markets Research, based on materials from the NSSF.

3. Record-high profit levels

The NSSF reported realized return for 2006 of RMB 19.6 billion (approximately ¥300 billion; a year-on-year increase of 270%) and a realized rate of return of 9.34% (up 199% year on year), record highs in both cases (Exhibit 4). Looking at the time-weighted rates of return, the cumulative average annual realized rate of return since the NSSF was established is 3.89%, 2.84x the cumulative average annual inflation rate over the same period of 1.37%. The cumulative realized return (excluding funds managed on behalf of basic pension system personal accounts) since the NSSF was established is 13.19% of NSSF equity and 15.30% of governmental allotments.

III. 2007 NSSF management plan

The NSSF's 2007 management plan is primarily based on drafting and revising relevant regulations and on reviewing investment asset allocations.

1. Drafting and revising relevant regulations

Draft a new Regulations for National Social Security Fund. The task of drafting said regulations is included in the State Council's legislative agenda. Accelerate work aimed at revising the Interim Measures on the Administration of the Investment of National Social Security Fund which was promulgated and implemented on 13 December 2001.

2. Review of investment asset allocations

Putting safety first, control risks, strengthen operations, and improve returns.

Although the allocations in its medium- to long-term investment portfolio were set at (1) 55-65% in fixed-income products, (2) 20-30% in corporate stock, and (3) 10-20% in business investments,[8] the NSSF decided to change the allocation to fixed income products to 50-70%.[9]

Based on this, investment asset allocations for 2007 were set as follows. Fixed income products shall comprise a minimum of 50% of the portfolio, and the targeted annual rate of return is at least 3.5%. Equities shall comprise a maximum of 30% of the portfolio, to be obtained through rebalancing and structural adjustments. A maximum of 20% of the portfolio shall be strategically allocated to business investments, with a targeted annual rate of return of at least 6%. Cash and cash equivalents shall be held as close to zero as possible, with a targeted annual rate of return above the rate paid on a one-year time deposit.

IV. Future trends

On 26 April 2007, NSSF Vice Chairman Gao Xiqing announced plans to lower allocation to equities, on a market-value basis, from the current 39%[10] to 30%.[11] We think this statement was primarily aimed at reiterating, to both domestic and overseas audiences, the revised asset allocations published in the Council's April report. The Council's report also indicated that the NSSF plans overall investments in 2007 of

8 The acquisition of shares associated with the listing of critical state-owned enterprises is classified as business investment.

9 There has yet to be any announcement as to what adjustments to other investment allocations have been made to offset the revision in fixed income allocation.

10 The actual allocation to corporate stocks at end-2006 was 34.2%.

11 "NSSF sells off shares amid strong market", *South China Morning Post*, 27 April 2007.

over RMB 100 billion (approximately ¥1.55 trillion). Although the report did not present any specific plans concerning the overseas investment activity that the NSSF began in 2006, there is unlikely to be any change in the trend of the NSSF becoming an increasingly important participant in both Chinese and overseas capital markets.

The NSSF is also viewed as a lifeline for China's citizens at large, and how successfully the fund is managed is clearly important from the standpoint of social security policies.