Abstract

In the process of the development, establishment and improvement of industrialization, the pension system has played an important role in maintaining social stability and promoting economic development, and it became the safety valve of social and economic operation.

Chinese introduced the pension system under direction of socialist ideology, the reform of the system is mainly carried out by government’s executive order, and distribute to other places. However, with the establishment of China’s market economy system, the pension system has also undergone a structural change, such as the implementation of multi-level pension system, government policy and private account system, and the rural pension insurance system.

South Korea made “National Welfare Pension Law” in 1973, and it was formally implemented in 1988. Prominent features of the pension system are as follows: the legal form of the implementation system, expand coverage on the basis of the number of workers, businesses and individuals share contribution rate of 4.5% of one’s salary. In addition, South Korea has also focused on the financial stability of pension funds, since 1988, investment funds was used, with “profitability, stability, publicity, liquidity, operational independence” as the basic investment principles, pursuit transparent and effective pension fund investment. Also, the country developed annual “Investment Policy White Paper” which clearly defined objectives and long-term asset allocation strategy, investment benchmarks and prevention mechanisms, recruitment agencies and other specially commissioned content, to facilitate investment management and efficiency. From 2007 to 2015, investment income rate has maintained at a high level, reaching an average 5.64 percent.

Even though the People’s Republic of China (hereinafter China) has improved its pension insurance system, the country’s aging population, eroding ability to pay benefits, asymmetric regional financial burdens, and considerable transition costs present problems in managing pension funds, preserving and increasing their valuations, and improving investment mechanisms. In fund management, in order to improve the effectiveness of fund management, China needs to create investment management suited to China’s Pension Insurance System, seek for diversified investors and investment targets, establish policies and targets for pension fund investments and management and better supervision of investments as South Korea such measures will have a positive impact on the future of reform and design.

This paper based on the basic content of pension fund management and the inherent requirements of the system design. It combines theoretical precedents and case analyses to apply the principles underlying pension fund management in Korea to China. It analyzes the national conditions in China and its pension operations, identifies problems, and proposes solutions.

[Keywords] Pension Fund, Pension Fund Investment Crisis, Pension Fund Investment Management in Korea, Countermeasure Analysis, Pension System
1. Introduction

In this study, pension insurance refers to a partially-funded retirement program in which balances that are not immediately paid as benefits are invested in legally approved vehicles. The People’s Republic of China (hereinafter China) is transforming from pay-as-you-go to partially funded pension insurance[1]. Able management is essential for this undertaking as pension payments support social and economic development, as well as personal and social stability. Fund balances are expected to increase continuously as China improves its pension insurance system. A reliable and effective mechanism of managing investments preserves and increases pension fund valuations and guarantees the ability to pay benefits[2].

This study proceeds as follows: Section 2 explains China’s pension system, identifies problems, and discusses investment operations. Section 3 analyzes pension fund management, investment policies, and operating conditions in the Republic of Korea (hereinafter Korea) and identifies the factors that make its program successful. Section 4 discusses the application of Korea’s example to China.

2. Pension Fund Operations and Problems in China

Guaranteed security is the first principle of pension fund investment in China. Decrees in the State Council on the Establishment of a Unified Basic Old-age Insurance System for Enterprise Employees issued in 1997 subject basic pension insurance to controls that assure that funds benefit retirees[3]. All balances beyond those needed for two months of benefits must be invested in bonds and deposited in a special account. Investment in financial and operating businesses is forbidden.

As per the 2002 Notice on RMB Agreement Deposit of Individual Account Fund for Pension Insurance Handled by Commercial Banks issued by the People's Bank of China (BoC), provincial social insurance agencies may contract commercial banks to hold deposits in individual pension insurance accounts. In November 2005, the Ministry of Finance (MoF) and the former Ministry of Labor and Social Security jointly issued the Notice on Relevant Issues of Expanding and Consolidating the Individual Account for Basic Pension Insurance for Enterprise Employees on a Pilot Basis[4]. It stipulates that monies in consolidated individual accounts should be subject to unified management by provincial governments and that the central financial subsidy should be entrusted by the provincial government to the National Council for Social Security Fund for investment and operation, with a specified rate of return. Apart from the central financial subsidy, individual accounts should be managed locally.

China has gradually improved the social security system covering urban and rural areas. Pension fund accumulation has increased rapidly. The basic employees’ pension insurance system has been combined with the institutional units’ pension insurance system. Bank deposits and purchases of national debt stipulated by existing policies have not preserved or increased fund valuations or assured payment of benefits. As economic development becomes China’s “new normal,” its aging population imposes greater pressure on the payment of pension fund benefits. To improve investment policies, expand investment channels, increase basic pension insurance fund income, preserve and increase fund valuations, and sustain the pension insurance system, the Ministry of Human Resources and Social Security, the MoF, and other departments in 2015 jointly drafted the Basic Pension Insurance Fund Investment Management Measures. Its purpose was “enhancing the social insurance fund investment management and supervision and promoting the market-oriented and diversified investment operation of the fund” as stipulated by the Third Plenary Session of the 18th Central Committee.

It is stipulated in the Measures that pension fund investments should observe the
principles of market orientation, diversification, and specialization. Fund valuations should be preserved and increased, and the security and liquidity of assets should be guaranteed. The urban employees’ pension fund earned CNY 2,934.1 billion during 2015, up 15.9% from 2014, including an income of CNY 2,301.6 billion collected from the urban employees, up 12.6% over 2014. Subsidies for the pension insurance fund reached CNY 471.6 billion. The total expenditure for 2015 was CNY 2,581.3 billion, up 18.7% from 2014. By yearend, the urban employees’ pension insurance fund was valued at CNY 3,534.5 billion, thereby meeting the 17.7-month payment requirement[5].

It is necessary to allocate pension fund portfolios in a manner that moderates investment risk and guarantees fund security; however, current policy faces four long-term problems:

2.1. Difficulty in preserving and increasing valuations

China strictly controls permissible pension investments. Throughout 2001–2015, the interest paid on demand deposits at the BoC generally lagged increases in consumer prices. As that gap widens, the security of urban employees’ pension insurance funds deposited in banks is only nominally guaranteed[6].

2.2. Poor financial sustainability

Since China combined social pooling with individual accounts, no accumulation of pension fund has been made for real. All funds are used to fill up the individual accounts, while the individual accounts are still empty (with book amounts but no actual fund). The root cause is that how to cover the implicit pension debt left by the old system was not clearly stipulated upon the establishment of the new system. Therefore, local governments have had to appropriate monies from the individual account fund to pay current benefits. Draining individual accounts to pay pooled benefits cannot guarantee long-term payments as China’s population grays.

2.3. Asymmetric provincial burdens

The urban employees’ pension fund faces significant provincial differences in obligations, pension coverage, and balances of revenue and expenditure. The more economically developed the province, the less the support for the urban employees’ pension insurance system and the greater the accumulated balances in the fund. The opposite is true in economically backward provinces. Without fiscal symmetry among provinces, central financing bears greater transfer payment burdens and provincial inequities persist. China’s current system might exacerbate these provincial imbalances.

2.4. Shifting population

China’s population is living longer, with a declining birth rate and a dwindling working-age population. According to the United Nations Population Division, 2015 was a turning point in China’s demographics. In 2015, China’s working-age population(ages 15–64) was 996 million. The number is expected to be 909 million in 2025, 829 million in 2045, and 734 million in 2055. The population above the age of 65 years will grow from 130 million in 2015 to 229 million in 2030 and 323 million in 2045. China’s current pension system is unsustainable under these projections.

3. Pension Fund Operations in Korea

Korea instituted pension insurance in 1988. It was designed as an accumulation fund to pay old-age pension. The system can assure benefits to citizens despite Korea’s increasing elderly population and problematic dependency ratio[7]. The government requires workers to pay into a long-term trust. Beneficiaries who satisfy actuarial conditions for payments and withdrawals can obtain liability reserve funds. Despite its relatively brief history, this system has grown rapidly and invests effectively.

In 1988, Korea’s pension fund was KRW 528.2 billion. Since 1994, the Public Management Fund Committee has used its monies to construct social service facilities, including loans for kindergartens(1994), old-age welfare facilities(1995), and International Monetary Fund(IMF) support for the unemployed
(1998). To facilitate systematization, effectiveness, and professionalism, Korea's Ministry for Health and Welfare (MHW) established a pension fund headquarters and reformed operating procedures in 1999. It successively introduced domestic entrusted operations, venture investment cooperation, foreign stock entrusted operations, and other investment methods. These steps increased the return on investment (ROI) [8]. During 2015, the income from pension funds was KRW 580 trillion, including KRW 403 trillion from premiums and KRW 176 trillion from investments, representing 69.5% and 30.3%, respectively. At yearend, the total expenditure was KRW 126 trillion, including KRW 120 trillion in benefit payments and KRW 6 trillion in management fees. The accumulated funds amounted to KRW 454 trillion [9].

Korea initiated market-oriented investment practices in 1988; however, the ROI of pension funds has declined since 1990, presumably reflecting declining global interest rates. ROI collapsed in 1997 when an exchange-rate crisis precipitated a stock market crash and improved with the market in 1998. Performance and valuations evaporated during the 2008 global financial crisis and the 2013 European debt crisis [Table 1]. Massive central bank easing prompted a reduction in funds’ foreign investment, and ROI fell again. In 2015, it was 4.57%.

Table 1. Historical annual average ROI of Korea’s pension funds [9].

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>Annual average(%)</th>
</tr>
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<tbody>
<tr>
<td>ROI(%)</td>
<td>6.86</td>
<td>-0.19</td>
<td>10.41</td>
<td>10.39</td>
<td>2.31</td>
<td>7.00</td>
<td>4.19</td>
<td>5.25</td>
<td>4.57</td>
<td>5.64</td>
</tr>
</tbody>
</table>

Korea’s pension funds achieved impressive ROI for three reasons.

1) Effective operations. Pension funds in Korea are managed by National Pension Service (NPS) and supervised by the National Pension Fund Operation Committee (NPFOC) organized by MHW. NPFOC oversees funds’ policies, interest rate agreements, operating plans, and results. NPFOC adopted a triangular system of government, users (enterprises), and labor. MHW tasked NPS with administering pension insurance (including investments). Korea effectively supervises the independent administration and management of its social insurance system. MHW reviews revenues, expenditures, and operations to maintain each party’s interests [10].

The profitability and transparency of Korea’s pension funds are strengthened. The interests of applicants (beneficiaries) are maximized through legal supervision and monitoring by the media (TV, newspapers, specialty websites). Trusteeship increases managerial transparency and ROI, thus assuring financial sustainability.

2) Specialized investment management. Korea sticks to its adoption of a partly trust management model directly managed by the government, which consists of NPFOC, NPS and the investment manager. In short, NPFOC and NPS have a trust relationship, and NPS and the investment manager have a principal–agent relationship. NPFOC develops the system and sets policies. NPS acts as a special body that is responsible for pension services, management supervision, and fund valuation. It collects premiums, determines and issues pensions, manages applicants, assesses policy and fund operations, and studies financial trends [11].

Korea observes five investment principles: profitability, stability, visibility, liquidity, and independence. Investment managers are selected on the merits of their qualifications and suitability for a principal–agent relation-
ship. These practices facilitate investment diversification and decentralization, thereby reducing risks and increasing ROI.

3) Diversified investment. Diversification is a matter of methods and partially entrusted investment. Asset allocation is based on Markowitz and other modern portfolio theories. In 2015, assets consisted of 51.4% national bonds, 4% foreign bonds, 20.2% national stocks, 13.1% foreign stocks, and 11.5% alternative investments. Considering the narrowness of Korea’s domestic market and the economic influence of pension funds, foreign investment is expected to expand. A specialized corporate fiduciary conducts investment operations. Active management can alter the ratio of mid-cap and large-cap stocks to small-cap stocks. It also generates liquidity and ROI exceeding that of direct investment, thus promoting the development of Korea’s financial markets[12].

4. Improving Operations of China’s Pension Fund

4.1. Create investment management suited to China’s pension insurance system

China today provides basic pension insurance by combining social pooling and individual accounts. The accounts differ in how they raise funds, disburse payments, and manage their affairs. Social pooling raises funds on a pay-as-you-go basis, following the principle of “determination of revenue according to expenditure to enable a slight balance” and balances short-term revenue and expenditure. Individual accounts raise funds through accumulation, following the principle of “determination of expenditure according to revenue.” Some assets are raised in advance for special-purpose payments, which is a practice that benefits the system’s long-term financial balances[13].

Given the differences in the sources of funding, investment management that is suitable for both funds should be established to enable decentralized management. Decentralized management means that the social insurance authority oversees the administrative management of funds. The independent social insurance administration operates and manages social pooling accounts; an individual account management committee or fund manager operates individual account funds. The social insurance authority, the MoF, the social insurance fund supervision committee, and an external supervisor jointly direct the fund. This separation of powers delineates responsibility among departments, separates administration and fund management, and increases managerial efficiency.

4.2. Seek for diversified investors and investment targets

As capital markets expand, populations age, and pension fund obligations rise, social insurance organizations (individual account management committees) might hire investment managers to conduct diversified operations. That is China’s best current option. In Korea, the pension fund is operated by fund companies or specialized organizations. Specialized managers oversee high-risk assets, and social insurance organizations invest directly in low-risk assets (bonds). This system of capital allocation better diversifies risks and improves ROI. Incentive mechanisms and enhanced supervision of agents are needed to propel active investment.

4.3. Establish policies and targets for pension fund investments and management

As the scale of pension funds expands, it is becoming increasingly important for funds to preserve and increase valuations. Operations and management should be based on independence, accountability, and professionalism. Accountability requires a fairer system for evaluating asset allocation[14]. Independence means that fund managers should be independent of the government. Professionalism means that the committee should consist of professionals, which boosts the efficiency of fund management and investment operations[15]. With these three principles, the fund management and operation committee can advance in the right direction while preserving and increasing valuations.

Funds should operate to produce benefits for beneficiaries, and operating principles
should be tailored to that goal. Investments in national debt and bank deposits should be reduced, and investment in domestic and foreign equities should be increased. In other words, China needs more active and open investments. Potentially higher risks can be held within a permissible range while pursuing results.

4.4. Better supervision of investments

Given its special status, China’s individual account system demands strict investment supervision. To protect the interests of beneficiaries, the supervision and control of social insurance organizations and investment managers must be enhanced externally[5]. The mechanism for supervising investment operations should be established alongside investment operations lest investments and operations be poorly regulated and controlled. What’s more, laws and regulations must assure the authority and validity of supervision. Guidelines for investment risks should be researched. A specialized organization should monitor risks and moderate losses.

5. References

5.1. Journal articles


5.2. Thesis degree


5.3. Additional references

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