

Pension Fund Reforms in China: An Opportunity to Promote Codes of Conduct and Standards of Best Practice

A background paper and request for input from CFA Institute members

by the Asia Pacific Office of the CFA Institute Centre for Financial Market Integrity

The objective of this paper is to provide an overview of the pension market in China and the changes currently underway to create a national pension system with universal coverage for its population. A functional national pension system in the world's most populated country will require high levels of transparency and governance, well-defined reporting standards, and strong risk control mechanisms.

Various CFA Institute codes and standards—particularly the *Code of Ethics*, *Standards of Professional Conduct*, *Code of Conduct for Members of a Pension Scheme Governing Body*, *Asset Manager Code of Professional Conduct*, and *Global Investment Performance Standards (GIPS)*—can be used to help promote the development of the Chinese pension market and ensure the inclusion of experienced, qualified trustees, administrators, investment managers, custodians, and of course, beneficiaries. We invite interested CFA Institute members who would like to get involved in promoting these codes and standards in the Chinese market to e-mail us at cfacentre@cfainstitute.org.

One Child Policy, Iron Rice Bowl Policy, and Family Safety Net

The Chinese government is presently undergoing important reforms to build a sustainable, nationwide pension system to provide for the retirement needs of its 1.3 billion people. The rapid population growth recorded in the 1950s and 1960s, followed by the “one child policy” instituted in the late 1970s, and the longer life expectancy of its populace due to improving health standards, are all important factors leading to rapid increases in the old age dependency ratio.¹ A recent study by the International Monetary Fund indicates that China's working population (as a percentage of its entire population) is expected to peak in 2010 and decrease thereafter. In addition, the median age of the population is predicted to increase from 32 years in 2005 to 48 years in 2050.²

China historically promulgated an “iron rice bowl” policy, which was a cradle-to-grave social safety net inherently part of the Chinese socialistic doctrine. However, this policy increasingly became untenable after the government instituted economic reforms in the 1970s and 1980s in an effort to transition to a more market-oriented economy. These reforms led to large-scale restructuring at state-owned enterprises (SOEs) and nullified the implicit guarantee of lifetime employment for SOE employees. In particular, the large-scale restructuring efforts implemented at SOEs between 1997 and 2005 resulted in an estimated one-third reduction (35 million workers) in SOE employment, thereby putting more strain on the existing social security system over a relatively short period of time.³

In addition to the iron rice bowl policy, an informal safety net was historically provided by the family tradition of younger generations taking care of family elders. However, much like the now obsolete iron rice bowl policy, relying on family support is no longer a sufficient means of providing for the nation's burgeoning retirement needs either, despite China's high savings rate. One of the most challenging

¹ Defined as the ratio of population aged 65 and over to the population aged 15-64.

² Steven Dunaway and Vivek Arora, “Pension Reform in China: The Need for a New Approach,” *IMF Working Paper* (May 2007).

³ *Ibid.*

legacies of the one child policy is that each generation's one child, once he or she reaches adulthood and enters the workforce, is confronted with the prospect of having to provide for two living parents and four grandparents while also providing for his or her own family and retirement needs.

Beginning in the 1950s, the Chinese government implemented various public pension plans. Reforms in the 1970s led to coverage plans for SOE and public sector employees (e.g., government officials, military, civil servants), but rural workers and self-employed workers were not included. The government introduced a rural social security insurance plan for farmers in 1992, and various projects were adopted in a number of rural provinces and districts but no such plans were implemented at the national level.⁴ These rural projects were voluntary schemes with low participation levels and a lack of government funding; policy makers were ultimately unsuccessful in establishing a comprehensive, sustainable pension scheme for the rural population. The migrant population (representing approximately 15 percent of the Chinese labor force) has also historically lacked pension coverage.⁵ Further, migrant workers often focused more on their immediate income than on future pension benefits and were quick to relocate to areas where better employment opportunities existed.

Reforms in the 1990s

The Chinese government began to restructure its national pension system in the 1990s by selectively establishing a two-pillar state pension system in the urban areas. This pension system was administered at the provincial or local government level instead of by the central government. Policy makers implemented the two-pillar plan as follows:

Pillar IA – a defined-benefit social pension provided through mandatory contributions solely by employers, equal to 20 percent of employees' income. This plan was administered at the provincial level by social security bureaus, and retirees received 35 percent of average monthly income. This plan was designed as a pay-as-you-go (PAYG⁶) system, with any gaps between contributions and benefits funded by the government.

Pillar IB – a mandatory, defined-contribution individual system funded by employees contributing 8 percent of their monthly income. These contributions accumulated in individual employee accounts until retirement. This system was also administered at the provincial level.

In 1997, the government published *State Council Document No. 26, Establishment of a Unified Basic Pension System for Enterprise Employees*, which announced a new, multi-pillar pension system with the ambitious goal of replacing all provincial pilot programs and providing coverage for the entire urban working population by 2000⁷; this goal ultimately was not achieved within this short timeframe. Under this new policy, coverage was expanded from the public sector to include foreign companies, the private sector, and the self-employed. This policy was rolled out to a number of provinces and municipalities, with the intention that it would be extended nationwide over time. In 2001, the government introduced the "Pilot Program for Improving Urban Social Security System," which was a test project to set up a

⁴ Yvonne Sin, "Understanding China's Pension System – Yesterday, Today and Tomorrow," *Watson Wyatt Worldwide* (November 2008).

⁵ Felix Salditt, Peter Whiteford and Willem Adema, "Pension Reform in China: Progress and Prospects," *OECD Social, Employment and Migration Working Papers* (2007).

⁶ In PAYG pension plan, benefits are paid to beneficiaries and are funded by the employer out of current income.

⁷ Yu-Wei Hu, "China's Pension Reform: A Precondition Approach," *Global Economic Review* (December 2006).

fully-funded, provincial pension system, in the Liaoning province in northeast China. By 2006, similar plans covered a total of 11 provinces (including Liaoning), accounting for 38 percent of the national population.⁸

In addition to these plans, China’s policymakers also introduced Pillar II and III plans for the urban sector with the long-term goals of creating more private, voluntary occupational pension schemes—comparable to those in more developed economies—and achieving less dependence on government funding for China’s national retirement needs.

Pillar II plans are voluntary, defined-contribution plans established by eligible employers such as large SOEs. These plans are commonly known as Enterprise Annuities (EA) or voluntary occupational pensions and are similar to the American 401(k) plans. EA plans were introduced in China in 2004 although a number of voluntary pension schemes were already adopted by SOEs—though were not properly regulated—in the 1990s.⁹ EA administration centres were established in some cities and regions to manage their local pension funds, while in other regions, EA funds were managed by local social security bureaus and invested in bank deposits or government bonds. In addition, a few state-owned industries in China (e.g., electricity, petroleum, railways) set up internal EA plans with their own administration centres.¹⁰ By the end of 2005, more than 24,000 companies had established EA plans covering more than 9 million employees.¹¹

Pillar III plans include other, voluntary, private schemes that do not conform to EA plans. Some forms of these private pension plans have already been implemented in China.

Summary of the Multi-Pillar System

	Contributions	Benefits
Pillar IA (PAYG)	Mandatory employer contribution of 20% of employee’s income	35% of average monthly income (after 15 years of employment)
Pillar IB (individual account)	Mandatory employee contribution of 8% of monthly income	Target replacement rate of 24% of average monthly income
Pillar II (EA)	Voluntary contributions by employers and employees	Individual account
Pillar III	Voluntary contributions by employees	Individual account

To date, each element of the Chinese multi-pillar pension system has had varying degrees of success. Policymakers’ primary objective was to improve pension coverage for the urban sector, while coverage for the rural and migrant sectors was a lesser priority. Many unprofitable SOEs were not able to provide

⁸ Yuande Zhu, “Latest Development of China’s Pension Market,” *Pension Trends*, BBVA (March 10, 2009).

⁹ Yu-Wei Hu and Fiona Stewart, “Licensing Regulation and the Supervisory Structure of Private Pensions: International Experience and Implications for China,” *OECD* (January 2009).

¹⁰ Yu-Wei Hu, Colin Pugh, Fiona Stewart and Juan Yermo, “Collective Pension Funds: International Evidence and Implications for China’s Enterprise Annuities Reform,” *OECD Working Papers on Insurance and Private Pensions No.9* (August 2007).

¹¹ Salditt, Whiteford and Adema, “Pension Reform in China: Progress and Prospects.”

sufficient funds to support these pension plans; results were mixed across the provinces, as some provinces were more successful than others. In addition, Pillar 1B has not been very successful, with funds accumulated in Pillar 1B accounts used to pay pension obligations in Pillar 1A, effectively operating as a PAYG system.¹²

China's Regulatory and Legal Framework

Presently the Ministry of Human Resources and Social Security (MOHRSS) is the primary regulator of both the public and private pension systems in China. Three other regulators—China Insurance Regulatory Commission (CIRC), China Banking Regulatory Commission (CBRC), and China Securities Regulatory Commission (CSRC)—have important roles as they regulate the institutions and sectors (insurance, banking and securities, respectively) that provide investment products and are involved in the overall development of the pension system. Other regulatory bodies also play important roles in the development of the national pension policy framework, including the State-Owned Assets Supervision and Administration Commission (SASAC), the Ministry of Finance (MOF), and the State Taxation Administration (STA). In addition, the National Development and Reform Commission (NDRC), which has broad administrative and planning control over the Chinese economy, and the People's Bank of China (PBOC), the central bank, also have a vested interest in national pension policy.

Setting up Pillar II and III plans also requires the establishment of four separate, licensed players: trustees, administrators, investment managers, and custodians. Licenses for these players are issued by the MOHRSS and are subject to renewal every three years.¹³ Any financial institution is allowed to apply for each license but the investment manager and custodian cannot be the same institution. Each license also has minimum capital requirements. It should be noted that the requirement of four separate licenses is unique to China as other jurisdictions typically do not require so many separate licenses. Moreover, other jurisdictions usually issue license for longer periods. In 2005, 37 financial institutions had licenses to manage EA assets in China and in 2007, 24 more licenses were issued.¹⁴ EA plan assets are presently estimated at RMB152 billion (or approximately USD22 billion at current exchange rates)¹⁵; the EA market in China is expected to grow to USD1.8 trillion by 2030.¹⁶

Summary of MOHRSS Licensing Requirements

Type	License Renewal	Minimum Capital Requirement
Trustee	Yes	RMB100 million
Custodian	Yes	RMB5 billion
Investment management	Yes	RMB1 billion or RMB100 million
Administration	Yes	RMB50 million

Note: all licenses subject to renewal every 3 years

¹² Hu and Stewart, "Licensing Regulation and the Supervisory Structure of Private Pensions: International Experience and Implications for China."

¹³ Ibid.

¹⁴ Ibid.

¹⁵ Ibid.

¹⁶ Yu-Wei Hu, Fiona Stewart and Juan Yermo, "Pension Fund Investment and Regulation: An International Perspective and Implications for China's Pension System," *OECD* (November 2007).

EA plans were set up under trust law, a concept that was only introduced to China in 2001, making it a relatively new element of China's legal system, which has traditionally been rooted in a civil law system similar to continental Europe's. The concept of trust law and its ability to segregate the assets of pension members during times of stress and bankruptcy are yet untested in China. The evolution of trust law through the Chinese judicial system will be a key factor in building public confidence in a national pension system.

Under current Chinese regulations, Pillar II EA plans adhere to either the internal or external trustee model; internal trustees are called pension councils (i.e. a board of trustees composed of both employers and employees with at least one-third of board members who are employees¹⁷). External trustees are financial institutions and known as professional or corporate trustees.¹⁸ The internal trustee model decrees that administrative, investment management, and custodial services are outsourced, whereas the external trustee model allows the administrative and investment management functions to be internalized if trustees are appropriately licensed by MOHRSS. However, it should be noted that under both models, the trustee's fiduciary responsibilities to the pension plan beneficiaries cannot be outsourced.¹⁹

All pillar plans were traditionally subject to the quantitative asset restrictions (QAR) regulatory approach, which imposes strict limits on holdings in various asset classes. Regulations placed conservative investment limits on asset classes for Pillar IB and Pillar II schemes. Pillar IB investments were restricted to bank deposits and government bonds. Pillar II assets could only be invested in the domestic market and required a minimum of 20 percent invested in government bonds, and investments in equities and equity mutual funds were limited to 30 percent of the plan assets.

Challenges for China's Pension System

More than half of China's population lives in rural areas, and as a legacy of past economic and pension policies, there is great disparity in both economic development and pension coverage between the urban (mainly the eastern coastal areas) and rural sectors (mainly the western provinces); the urban population is generally better covered while both the rural and migrant populations largely sit outside the scope of any pension coverage. The *hukou* household registration system, which was used to control the movement of people between urban and rural areas, helped contribute to the urban-rural divide. Many of the most productive workers from the rural areas migrated to the urban areas for more attractive employment opportunities, but were not able to enjoy urban social security benefits because they were not registered under the *hukou* system.

Migrant workers are disadvantaged by the lack of portability of their accumulated benefits in their pension accounts from their present employers; they risk giving up their accumulated benefits in one location when they move and take new positions in different cities and provinces. Administratively and logistically, it is proving difficult for government officials to transfer accounts across different provinces and cities especially when migrant workers have a tendency to move frequently for immediate employment opportunities. Hence, migrant workers lose out financially when they eventually return to their home provinces and cannot collect pension benefits from past employment.

¹⁷ Hu and Stewart, "Licensing Regulation and the Supervisory Structure of Private Pensions: International Experience and Implications for China."

¹⁸ Yu-Wei Hu, Colin Pugh and Fiona Stewart, "Trustee Responsibilities," *OECD* (2008).

¹⁹ Yu-Wei Hu and Fiona Stewart, "Pension Fund Governance: International Experiences and Lessons Relevant for China's Pension Reform," *OECD* (2006).

Indeed, the pension system and reform process have thus far largely ignored the rural sector and migrant worker population but policymakers understand the importance of including these groups more effectively going forward. According to MOHRSS, China's pension system covered just 15 percent of the population as of March 2008.²⁰ Hence, much work needs to be done to provide universal coverage for the greater population and reduce the regional income inequality levels across provinces. Given China's population demographics, a national pension system would by necessity become the largest such system in the world.

The existing pension system will not be sustainable as it cannot keep up with the low birth rate, aging demographic outlook, and the increasing old-age dependency ratio. Largely due to the "one child policy," the average birth rate per woman decreased from 3.4 in 1960 to 1.9 in 2003.²¹ One recent study estimates that almost one-third of China's population will be aged 60 and over by 2050.²² The average life expectancy for men and women is 70 years and 73 years, respectively.²³ Moreover, the aging of China's population is occurring at lower levels of per capita income and economic development relative to more developed countries such as Japan and the United States.²⁴ All of which means that, unlike these other countries, China is aging before becoming wealthy. And as previously mentioned, China's working population is expected to peak in 2010, thereafter resulting in increasingly greater burden on the working population to support their elders' retirement needs.

China's pension system is implemented through a decentralized system of administration which has made it difficult for the central government to effectively implement coherent national pension policy changes. Provincial and municipal authorities have large degrees of authority and discretion over pension plan administration; there is a general lack of cooperation between the central and provincial and municipal governments. The system is further complicated by entrusting a variety of different agencies with responsibility for the oversight and approval processes. China's policymakers also need to deal with the legacy costs from previous pension plans and the growing obligations from current pension plans. These large unfunded pension liabilities are related to the pension plans in place before the revised plans introduced in 1997; pension entitlements under the pre-1997 plans were generally more generous than subsequent ones but were largely unfunded.

Role of NSSF

The National Council for Social Security Funds (NCSSF) was established to provide funding and stability to China pension reforms; it is responsible for management of the National Social Security Fund (NSSF). NCSSF is made up of representatives from the central government and various ministries—namely the Ministry of Finance and the Ministry of Labor and Social Security (which became MOHRSS in 2008). The NSSF is funded by fiscal allocations from the central government and proceeds from public share sales (i.e. initial public offerings) of SOEs and national lotteries.

²⁰ Dune Lawrence, "China Faces Japan-Style Age Threat with Plan to Revamp Pensions," *Bloomberg* (April 21, 2009).

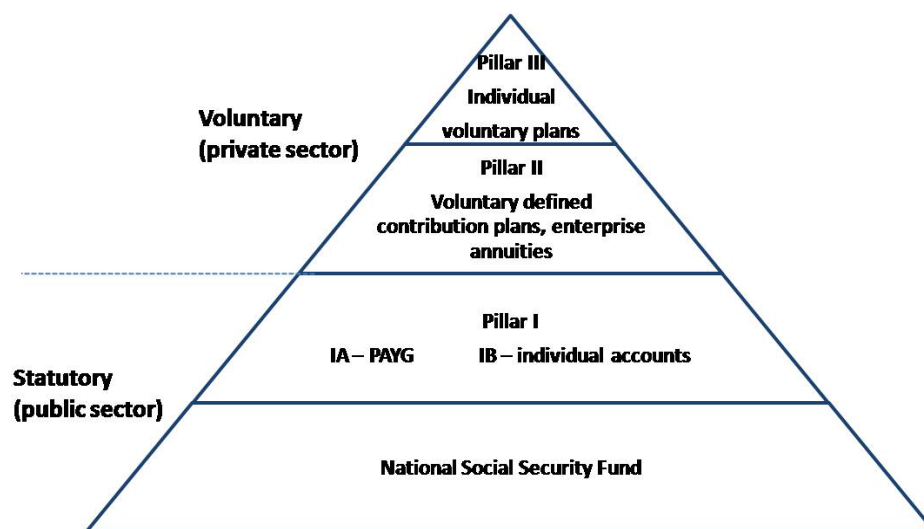
²¹ Yu-Wei Hu, "China's Pension Reform: A Precondition Approach," *Global Economic Review* (December 2006)

²² "World Population Ageing," *Department of Economic and Social Affairs, Population Division, United Nations* (2007).

²³ Dunaway and Arora, "Pension Reform in China: The Need for a New Approach," IMF Working Paper (2007).

²⁴ *Ibid.*

The NSSF’s current investments include two unlisted state-owned banks—China Development Bank and China Agricultural Bank—both of which are expected to conduct their IPOs in the future.²⁵ In June 2009, the State Council announced that locally-listed companies must transfer part of their state-owned stakes to the NSSF.²⁶ Government officials have made comments to the effect that the NCSSF should have an active role in fiscal policy.²⁷ However, this proposal is not without controversy. Many argue that the primary objective of a national pension policy is to manage pension assets prudently in order to provide for the rapidly growing retirement income needs of the Chinese population. Indeed, instead of making a national pension scheme an instrument of fiscal policy, some parties are calling for policymakers to allocate more capital from the fiscal stimulus plan to fund and support the development of a national pension plan for China.²⁸ In this same way, fiscal allocations from the central government are already partially funding the NSSF.



The NCSSF has restrictions on making overseas investments. Domestically, investments were made locally in equities, derivative products, and more illiquid alternative investments such as real estate and private equity. The NCSSF has recently announced that investments will continue to be made in unlisted companies and infrastructure projects.²⁹ Such investments are made in an effort to provide sufficient returns to meet current and future retirement needs. However, these investments, particularly in complex and illiquid products, need to be made with a full comprehension of the risks associated with the higher expected rates of return. The ongoing global financial crisis and downturn in global stock indices have adversely affected pension asset portfolios, although the recent market recovery may have reversed some of these losses. The NCSSF announced that the NSSF lost 6.75 percent in domestic equity investments in

²⁵ “China Pension Fund to Adjust Invest Structure in ’09,” *Dow Jones Chinese Financial Wire* (February 26, 2009).

²⁶ “China Pension Posts 9.99% Return,” *Asian Wall Street Journal* (July 13, 2009).

²⁷ “Funds Should Have Role in Fiscal Policy,” *Dow Jones Chinese Financial Wire* (November 10, 2008).

²⁸ Pieter Bottelier, “Where is Pension Reform Going in China? Issues and Options,” *Perspectives, Volume 3, No. 5* (June 30, 2002).

²⁹ “China Pension Fund to Adjust Invest Structure in ’09,” *Dow Jones Chinese Financial Wire*.

2008 (although mark-to-market accounting may result in higher recorded losses for that year).³⁰ However, due in part to the improved market sentiment, the NCSF recently reported that the NSSF recorded a 9.99 percent gain on equity investments for the first half of 2009.³¹

The Way Forward for China's Pension System

China's policymakers understand that social security reform and the creation of a functioning, national pension system, with both public and private components, are critical elements of a "harmonious society." Concrete, measurable reforms need to be implemented. To begin with, policy makers could consider increasing the mandatory retirement age to help address the inadequacies of the existing, unfunded pension system.³² In this way, would-be pensioners would have to work longer before they become eligible to collect benefits. However, this change in retirement age may be difficult to implement given the national employment situation. Indeed, a potential long-term threat to the stability of the pension system is the lack of employment opportunities for the nation's large supply of labor in the midst of the ongoing global financial crisis. New college graduates are entering the workforce in large numbers but are unable to find jobs. Migrant workers are returning to their home villages given the lack of employment opportunities in the urban areas. The implication is that the economically inactive population without an adequate social safety net is growing at a high rate, and without employment opportunities they cannot meaningfully contribute to the development of the national pension system, all of which could lead to labor unrest.

Increased portability of pension benefits between regions is important so that employees can collect accumulated balances when they relocate to different areas; indeed, increased portability of benefits would increase the efficiency of the labor market and overall labor mobility. As previously mentioned, migrant and rural workers are willing to relocate in order to find employment opportunities but this is less true for more qualified urban workers who fear losing their accumulated pension benefits.

China's policymakers have introduced a number of important new laws and regulations relevant to the pension reform drive; they aim to establish a comprehensive national pension system covering the entire population—urban, rural, and migrant—by 2020. The "11th Five-Year Plan" in 2006 called for the formation of a rural pension system. The Urban and Rural Planning Law was enacted in 2008 to better balance the economic development of the urban and rural populations. In December 2008, the standing committee of the National People's Congress released a draft of a national social insurance law; this draft calls for the pooling of Pillar I at the provincial level by the end of this year and at the national level by 2012. Hence, China is making progress in improving its regulatory and legal framework, which would provide the foundation for the creation of a national pension plan and incentivize greater participation by employers and employees alike.

Many industry practitioners are arguing for a new, autonomous national pension authority to be established independently of existing government bodies (national, provincial, local). Indeed, the existence of many different regulatory bodies with some overlapping roles may have hindered the development of the pension system so far. One school of thought argues that this system should be placed under the directive of the State Council, which is the chief administrative authority in the Chinese

³⁰ Ibid.

³¹ "China Pension Posts 9.99% Return," *Asian Wall Street Journal*.

³² Presently the retirement age is 60 years for men and 50-60 years (depending on occupation) for women.

government.³³ In this way, the State Council can be directly involved in the implementation of a new coherent, national pension system and ensure that regulators and the central and local governments are effectively implementing a coordinated pension policy.

The Chinese pension system is increasingly moving from the Quantitative Asset Restrictions (QAR) to the Prudent Person Rule (PPR) regulatory approach.³⁴ MOHRSS is currently reviewing the investment limits on pension plans with an open view to easing conservative investment restrictions toward a PPR approach. Investments in more asset classes and in overseas markets (which is currently permitted under the Qualified Domestic Institutional Investor or QDII scheme³⁵) are gradually opening up. The Chinese government established the NSSF in 2000 as a fund of “last resort” which could support the funding needs of the various pension schemes across the nation. Five domestic and joint venture firms were selected to manage NSSF assets in 2005, and the NSSF has invested in overseas markets since 2006 via investment mandates to foreign asset managers. However, restrictions on overseas investments by EA plans still exist.

Policymakers are encouraging private enterprises to establish more EA plans. Small- and medium-sized companies (SMEs) in particular need to adopt EA plans; thus far, growth of the EA market has primarily been limited to the large SOEs. The establishment of master trusts, whereby companies can pool their investments instead of each setting up individual trusts, could help to promote EA plan growth among SMEs.³⁶ Many industry practitioners are arguing for greater guidelines on tax exemptions for companies in order to incentivize them to set up more EA plans; tax regimes also vary across provinces and thus a consistent national tax policy on tax deductible contributions is needed. In April 2009, the Shanghai government announced a tax break plan to encourage such plans.³⁷ In addition, regulators should consider streamlining the licensing requirements for trustees, administrators, investment managers, and custodians, all of which are presently separately licensed by MOHRSS.

The development of China’s capital markets—equities, debt, derivatives—will play an important role in the development of the pension system. Investments will be made less in conservative, low risk, low return asset classes and increasingly in more sophisticated, innovative securities products in the search for higher risk-adjusted rewards. In this respect, equities investments via mutual funds in particular will become increasingly emphasized. The development of China’s pension system and capital markets need to go hand-in-hand. Relative to more developed markets, China’s capital markets are nascent, with shorter trading histories, less liquidity, less foreign investor participation, and a smaller institutional investor base. Also in line with capital market development is more rigorous accounting and reporting standards so that investors can be confident in companies’ financial statements.

Policymakers also realize that China needs a strong, well-capitalized financial sector, including banking, securities, and insurance, to support the development of its pension system; a robust banking system would provide credit, encourage savings, and facilitate the efficient operation and stability of the capital

³³ Dunaway and Arora, “Pension Reform in China: The Need for a New Approach.”

³⁴ PPR requires firms to invest prudently and follow broad principles of portfolio diversification, while QAR imposes strict limits on holdings in risky asset classes.

³⁵ This regulation allows mainland China residents to invest in overseas markets via selected institutions.

³⁶ Zhu, “Latest Development of China’s Pension Market.”

³⁷ “Shanghai Plans Tax Break for Pension Schemes,” *Reuters News* (April 1, 2009).

markets. In addition, a large portion of pension investments are held in bank deposits and bonds. Insurance companies are important because they provide annuity products to pension plans.

Role of CFA Institute in China's Pension Reform Drive

CFA Institute, as the global standard bearer for the investment profession, can play an important role in assisting China's policymakers in their drive to build a national pension system with universal coverage for the entire population. A well-functioning national pension system would need to have a high degree of transparency and governance, rigorous accounting and reporting standards, strong risk controls mechanisms, and high levels of administration. CFA Institute members, particularly those working in investment management and other financial institutions interested in the potential growth of the EA market, and multinationals with operations in China, will also be interested in the development of China's pension system.

Greater education and training about the benefits of a pension system will be helpful for all the key players in China's pension policy: policymakers, trustees, administrators, investment managers, and custodians. These players have fiduciary duties to become more knowledgeable and experienced in terms of financial, technical literacy and investment know-how, especially with increasing discretion over asset allocation policy in line with the anticipated growth of the EA market. Indeed, a strong pension fund governance structure calls for the establishment of well-defined plan objectives, a strong regulatory framework, proper internal controls, transparency, and regular monitoring and assessment of performance.

In addition, the general population, as participants and ultimately the beneficiaries of the pension system, also need to be educated about the benefits of a well-defined pension system. In fact, pension plans under the EA scheme shift the oversight responsibility from the government to the members themselves. These participants will need disclosure of relevant information about fund performance, the involved risks, and investment income on a regular basis.

The CFA Institute *Code of Ethics and Standards of Professional Conduct* outline ethical codes and standards for the investment profession; CFA Institute global members and CFA Program candidates annually must affirm their adherence to these standards. The CFA Institute *Code of Conduct for Members of a Pension Scheme Governing Body* (Pension Trustee Code) was derived from the *Code of Ethics and Standards of Professional Conduct*; it is a voluntary code that calls for best practice by members of a pension governing body when complying with their duties to the pension plan and serving the best interests of plan participants and beneficiaries; it is relevant for both public and private pension plans. This code promotes the principles of honesty, integrity, independence, fairness, openness, and competence; it provides guidance to individuals who oversee plan management with respect to their duties and responsibilities and should be followed in conjunction with the plan's overall policies and procedures. This code is globally applicable, creates a level playing field, and builds trust and confidence in participants and beneficiaries.

The Pension Trustee Code can be used as a template by China's pension players for the governance structure of NSSF and provincial funds. This code can also be used as a template for regulating trustees since it is aimed at individuals who are trustees of any type of pension plan. This code should grow in importance in line with the expected growth of EA plans in China.

A number of corruption scandals involving the misuse of pension funds by government officials in China highlight the importance of the need for a Pension Trustee Code in that market. Among the most prominent cases was the discovery in 2006 of the misuse of funds from the Shanghai Social Security Fund for speculative real estate projects. Investigators discovered that some of the investments did not follow the fund's guidelines and a number of government officials were jailed for corruption.³⁸ As a result of such scandals, the public's trust in the pension system has been adversely affected.

The CFA Institute *Asset Manager Code of Professional Conduct* outlines the ethical and professional responsibilities of firms that manage assets on behalf of their clients. Many global asset management firms are interested in the growth of China's pension plans and EA schemes in particular. As investments increasingly become more diversified outside of China and the NSSF outsources a greater portion of management of its pension assets, qualified investment managers will be able to win mandates. Pension fund managers will need to be able to make ethical, sound investment choices and follow well-defined, high standards of professional conduct. Thus, the Asset Manager Code would be relevant and can be incorporated into China's professional rules and regulations.

The *Global Investment Performance Standards* (GIPS), which promote the highest performance measurement and presentation standards, can help investment managers better measure investment performance and improve disclosure and reporting standards. Pension assets will need to be managed professionally with regular investment monitoring and adherence to these codes of conduct. In fact, GIPS compliance is already required for QDII funds in China.

China's pension policy has made great progress over the past two decades, evolving from an iron rice bowl/informal family social safety net to a largely unfunded pay-as-you-go system and more recently to a partly funded, multi-pillar system with both mandatory and voluntary components. China's policymakers have an important role in implementing regulations that encourage prudent management of pension fund assets, greater transparency and governance, and strong risk controls. All of these factors can lead to the development of a national, sustainable pension system, with both public and private plans, that can meet the burgeoning retirement needs of a rapidly aging population. CFA Institute can assist China's policymakers in their pension reform drive by promoting and providing training in best practices and the highest standards of ethics and codes of conduct. Policymakers, financial institutions interested in the development of the EA market, employers and pension participants, and beneficiaries can refer to the CFA Institute *Code of Ethics, Standards of Professional Conduct, Code of Conduct for Members of a Pension Scheme Governing Body, Asset Manager Code of Professional Conduct* and the *Global Investment Performance Standards*,³⁹ which are globally recognized and accepted, as they build a regulatory and operational framework for a nationwide pension system and thereby improve public confidence in the government's commitment to building such a system.

³⁸ Salditt, Whiteford and Adema, "Pension Reform in China: Progress and Prospects."

³⁹ More information on these codes and standards are available on the CFA Institute website (www.cfainstitute.org)

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