2009 Asian Pension Fund Roundtable
Mitigating Uncertainty: *Institutional Investors & Risk Management*
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Luncheon Keynote Remarks by **Dai Xianglong**, Chairman, National Council for Social Security Fund, People's Republic of China

I would like to thank the Pacific Pension Institute for holding this meeting, in particular because after a *very cold winter of financial crisis* it is especially nice to gather here in warm Bangkok. I think it is useful to have this meeting so as to draw lessons on risk management and to improve the management of our funds. It was said not too long ago that pension funds were the major players in financial markets because their total assets stood at around US$31 trillion, with the Asia-Pacific region accounting for about 70% of those funds. But we all know too well that after this financial crisis we have experienced on average, a 20% loss in global pension fund assets.

Although we continue to be very prudent in the management of our funds, it was inevitable and understandable that against the backdrop of the financial crisis, pension funds would incur losses. Still, it is important for us to draw some lessons from this crisis. And while each and every individual pension fund may have its own particular lessons to draw, there are certain lessons we all share in common.

Lesson one is that some pension funds relied too heavily on stocks. I think it is very dangerous to allocate up to 50-60% of a fund's investment in the stock market. That is too high. Lesson two is that pension funds may have not been careful enough in the selection and supervision of external fund managers. We have learned that we should choose managers who are focused on the long-term rather than those who seek very high returns over the short-run.

Lesson three is that those of us who manage pension funds must continue to work even after we have given mandates to external managers. That is to say that we should continue to closely follow developments in the markets, the economy, and the capital markets -- and adjust accordingly.

It was back in July 2007 that we saw the subprime crisis start to take hold in the United States. About one year later, we experienced the outbreak of what turned into an all-out financial crisis. Since that time, some pension funds have succeeded in avoiding major losses, and I think we can learn from their experiences.

In the aftermath of the financial crisis, the world economy has begun to turn from recession to recovery. International financial markets are stabilizing, and the cross-border flow of international capital is beginning to pick up. All in all, I think the international currency system dominated by the US dollar will not change fundamentally in the short run, nor will the international division of labor.

This is by way of saying that pension funds should notice not only those things that are changing, but also those that remain unchanged, and recalculate and readjust strategies accordingly.

In the face of the current crisis, the Chinese government has undertaken a series of measures which have produced significant results. From January to September, GDP grew by 7.7% in China, reflecting growth both in consumption and investment. It could happen that over the course of this entire year, we will see GDP growth of more than 8% GDP growth. And at the same time that the country's economy is speeding up, we intend to continue our efforts to improve our social insurance coverage and social security.

For urban workers, pension funds in China can be divided into three parts. The first part is social insurance. Each employee contributes 8% of his or her salary while the employer contributes about 20%. The total surplus of this scheme stands at about 1.5 trillion RMB (US$219.6 billion[1]). The second part is what are known as enterprise annuities, with a total surplus of about 200 billion RMB (US$29.3 billion), which keeps increasing.

[1] Exchange rate as of December 1, 2009

Because many of the individual accounts are not fully funded, China decided to establish the Social Security Fund (SSF) to bridge the future gap that we expect will arise as our population ages. SSF has several funding sources: 1) allocations from the central budget; 2) proceeds from lotteries; and 3) the equivalent of 10% of proceeds when state-owned enterprises are listed. Therefore, we anticipate that SSF will exceed one trillion RMB (US$146.4 billion) within one or two years' time.

As for SSF's overall asset mix, we have about 48% invested in fixed income products; 29% in securities or stocks, both at home and abroad; and less than 20% in the equities of non-listed enterprises such as private equity funds. About 5% is invested in cash and cash-equivalents. From January to September, our rate of return was positive. Over the past nine years, since the establishment of the National Social Security Fund, the average rate of return has been 9%.

We also would like to share with you some of the experiences we have had in connection with the management of the fund. The first point concerns the establishment of a board of directors. We currently have 21 directors, including current and former state leaders as well as ministers or vice-ministers from relevant ministries. There are also directors who are professionals and experts in finance. The board holds meetings every year during which they decide the asset allocation plan for the coming year and for the five-year period that follows. They also examine the work report of the chairman as well as the Fund's annual reports. It is then up to the chairman to implement those projects based on discussions with the Council and also with three specialized committees.

There are eight departments within the Council. Each works on a different area. Each and every project in which we intend to invest must be reviewed in the course of three rounds of discussions with relevant committees. Both of my predecessors are former ministers of finance, and I am the former governor of the Central Bank. From this you can see the great importance that the government attaches to the Council.

The second lesson or experience from our perspective is to insist on a prudent approach for investment. Within our fund, we now operate based on a three-part investment philosophy, namely, long-term investment; value investment; and responsible investment. For the moment, our long-term investment objective is to beat the rate of inflation. That is to say that over five years' time, the average annual rate of return should be no lower than 3.5%.

At the same time, we also maintain proportional control over the different classes with the intention of adjusting this percentage each quarter, annually and every five years in line with the micro-economic conditions and the market. When the stock market is too heated and our allocation to stocks is too high, then we will sell, and vice versa. So we will not be among those who buy a lot when the market is going up and dump a lot when the market is going down.

At this time, the government also is expanding the effort to improve the social security system. Social insurance coverage will be extended to farmers in addition to city dwellers. In the past, social insurance for city dwellers was managed at the local level. Beginning this year, management is being concentrated at the provincial level.

President Hu (Jintao) also has made it very clear that we are going to increase the Social Security Fund. Therefore, we need to improve our performance and achieve higher returns of investment. In order to do this, we first need to consider reforming our management system. Currently, the National Council for Social Security Fund is a ministerial level agency directly under the State Council. As such, salaries and other staffing decisions are treated the same as for civil servants.

Going forward, we are thinking of changing the nature of the agency so that it is like an investment management firm or a company of the Social Security Fund. That would allow us to attract more talent from the marketplace. I must emphasize that this is a topic for discussion and not yet decided. But I find it hard to believe that a government agency can run or manage a large fund with one trillion RMB (US$146.4 billion dollars).

Secondly, we need to restructure the portfolio and our asset allocation in line with the fact that we do not anticipate any major payouts over the next 10 years. So I think we could reduce the allocation to fixed income products. According to our regulations, 30% of our assets can be invested in non-listed enterprises and private equity funds. To invest that 30%, however, we will need a professional team. So, once again, I think we need to establish a subsidiary body.

Thirdly, we need to increase the percentage of our overseas investment. The figure now is 7%, and we hope to raise this to 20%.

Our colleagues who are present here represent both pension funds and financial institutions with a lot of experience both in the management of funds and the management of risk. So we are eager to learn from your experiences in order to do a better job in managing our own social security fund.

With that, I would like to wish this meeting a complete success. I also would like to wish you good luck in seeing your balance sheets increase in value after you return home. Thank you.

Question:
When do you think the RMB will be made fully convertible?

This financial crisis has raised the question of whether the current international currency system is fit. My answer is: I think there is a need for reform. But while reform is necessary, such reform will be a long-term and an arduous process.

US GDP is about one-fourth of the world's total, and of the total foreign exchange reserves in the world, about two-thirds are in US dollars. Also about 80% of international settlements are in US dollars. So I think the dollar's dominance in the international currency system is not going to change in the short run.

Still, there is a need to strike the correct balance between the US dollar as its own currency and as the international reserve currency. There are two ways to deal with this. One way is to press the United States to lower its deficit and to maintain a stable dollar. Because the US dollar is the international reserve currency, people simply cannot say that its value is decided by the market.

The second way is to diversify via international currencies. This is something that President Hu has raised. I believe the RMB can become an important currency in a basket of international currencies. That said I want to be clear that making the RMB fully convertible does not equal turning it into an international currency. An international currency still has to have multiple functions.

Some 16 years ago, the Chinese government said that we would make an effort to make the RMB convertible. To achieve this goal we realized we must do our own homework and do it well. First, we must adjust our financial structure. That is to say that the percentage of indirect financing is now too high, and that of direct financing, too low.

Second, we must restructure the existing currency structure. That is to say, we must maintain a very good international balance of payments. For the moment our foreign exchange reserve accounts for about one-third of total bank savings. Third, we must restructure the existing credit structure. That is to say, our banking operations need to be more market-oriented. For the moment, banks in China permit a large gap between the interest rate on loans and that on savings. The gap is as large as 3.1%, and this is much higher than the international market.

As for the RMB's convertibility, now under the capital account, only about one-fourth is still under administration. As a first step, we may have to make more room for foreign direct investment flows into certain industries in China. We also may need to approve more QFII licenses for investing into China and more QDII for taking RMB out of China for investment. And certainly, we need to create conditions to allow Chinese residents to buy foreign stocks directly. Finally, we need to further develop the bond market in China so that foreigners who hold RMB can invest into the Chinese markets.

Maybe there should be more currency swaps between RMB and foreign currencies at the national level. Here, I am not talking about a swap of the RMB into another international reserve currency. Rather, my reference is to a swap between two local currencies. China at this time has swap agreements with five or six countries with a total value of about 600 billion RMB (US$87.86 billion). This means that the foreign banks at the other end of the swap are given RMB. They then can transfer this money to domestic commercial banks, which in turn can come to China either to buy Chinese products or to ask Chinese banks to convert this currency into an international reserve currency.

In the future, foreign central banks and enterprises should be allowed to issue RMB bonds in Shanghai or other big cities in China.

As for the convertibility of RMB, maybe we first could allow convertibility between the RMB and the Hong Kong dollar as well as with the Australian dollar. Then we could expand the scope to neighboring countries. I think that the accelerated cooperation between ASEAN countries plus five is a fundamental step towards achieving this.

These are my perspectives on the conditions, steps, and channels that would be necessary for the RMB to become an international currency. Of course, I do not speak about these matters as the governor of the central bank but as an institutional investor. To sum up, I believe that the full-convertibility of the RMB will take time, at least 10 years. In the meantime, it is important for those of us who are investors to see that someday, it will be achieved. Thank you.