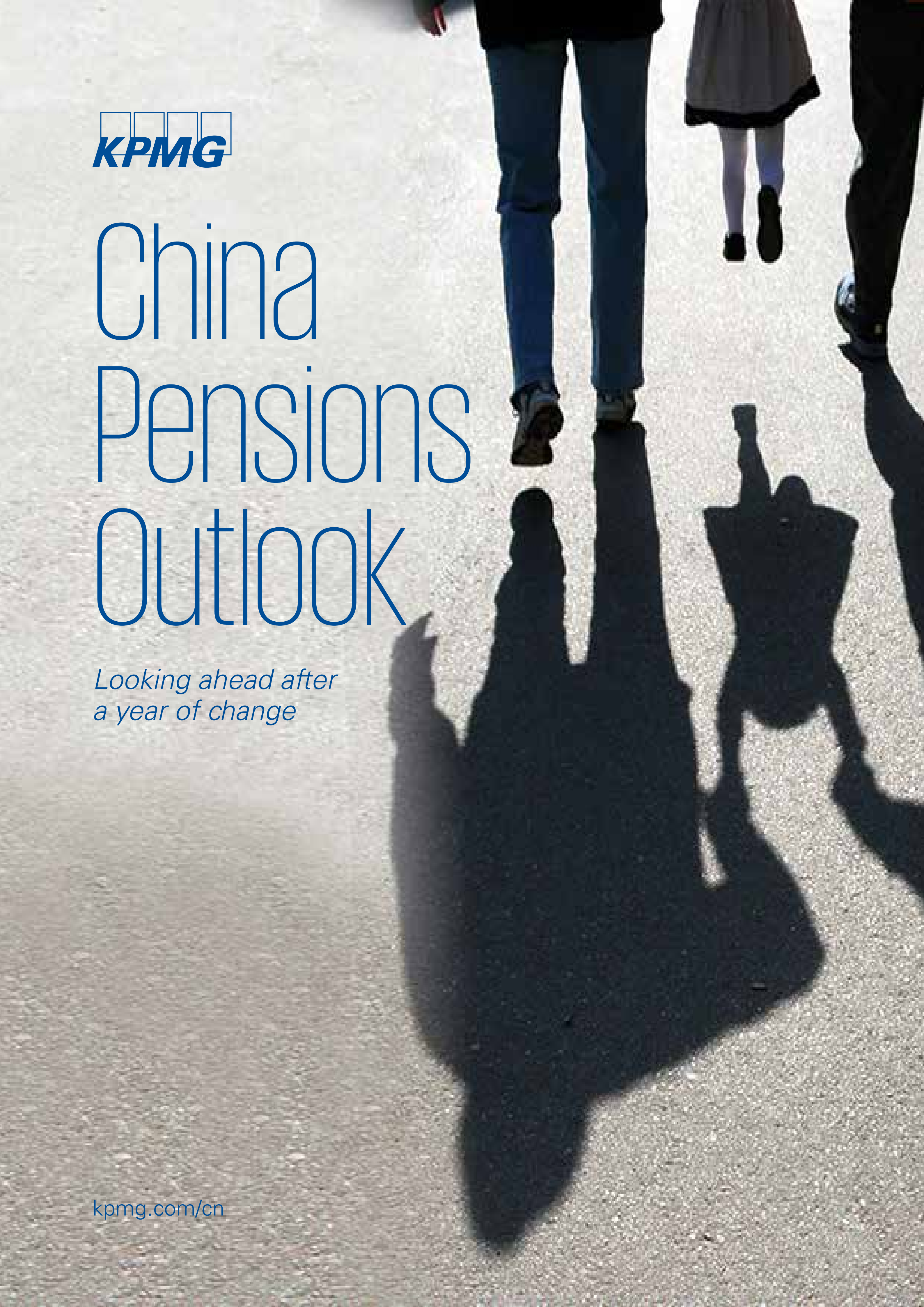

KPMG

China Pensions Outlook

Looking ahead after a year of change

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Contents

Introduction

Welcome to KPMG's fourth annual report tracking developments in China's pension industry. China's ageing demographics and the consequent challenges continued to draw attention during 2019 and triggered a number of fundamental changes.

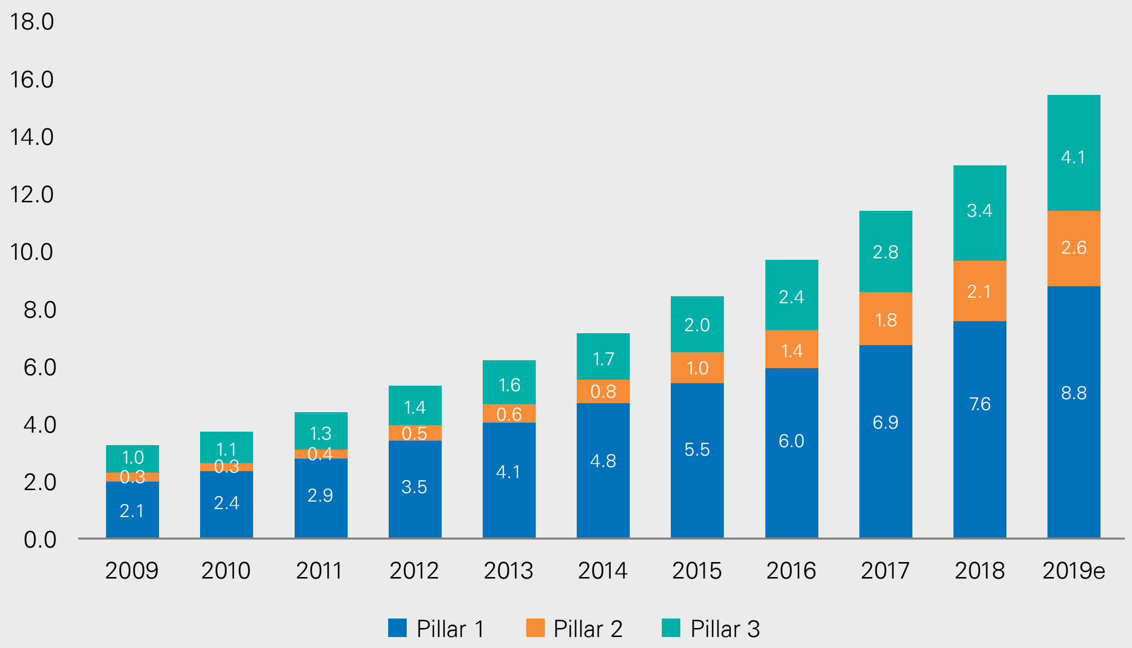
This report updates and builds on our research in China's pension industry. In the report, we analyse why Pillar One will continue to be the most important and fastest- developing sector of the pension system in China. We also offer our view on what supporting measures, in addition to tax incentives, are needed to restore the growth of Pillar Two and get Pillar Three off the ground. Lastly, we examine how increasing retail participation in the pension space will intensify competition and give rise to new business opportunities.

Year in review

There have been several significant developments over the last 12 months demonstrating that both government and the broader Chinese public are paying greater attention to the pension system. While the discussion around challenges faced by China's pension system continues to gain circulation, there were also a number of long-awaited regulatory changes. These included encouraging foreign entry into the pension management industry, the admission of the ninth pension insurer applicant, and new approval of pension annuities plans and mutual funds. Meanwhile, all three pillars of the pension industry continue to register growth, although at different paces.

We estimate that China's total pension assets grew by 19 percent in 2019 to more than RMB 15 trillion. This is a 2019 year-on-year growth rate similar to its long-term average of 17 percent recorded over the last decade. It would be slightly higher than the rate recorded in 2018, thanks to the development of occupational annuities and continued capital injection under Pillar One.

Distribution of Pillars 1, 2 and 3 since 2009



Sources: NCSSF, MoHRSS, CBIRC, CSRC and KPMG analysis

The following is a summary of the key development highlights affecting each pillar of the pension system.

1.1 Pillar One - Government scheme

1.1.1 Public Pension Fund

Public pension funds at the provincial level followed two directions during 2019. Both were set out as long-term development rails. On the one hand, the local public pension funds' immediate goal is still to deal with their worsening deficit. More and more provinces are reporting growing deficits and need to ask for subsidies; the most notable example is Heilongjiang province, which reported a negative net balance of RMB 56 billion. For those provinces that have been relying on subsidies to keep their system afloat, the level of support needed has also been rising. This is exacerbated by imbalances between different regions.

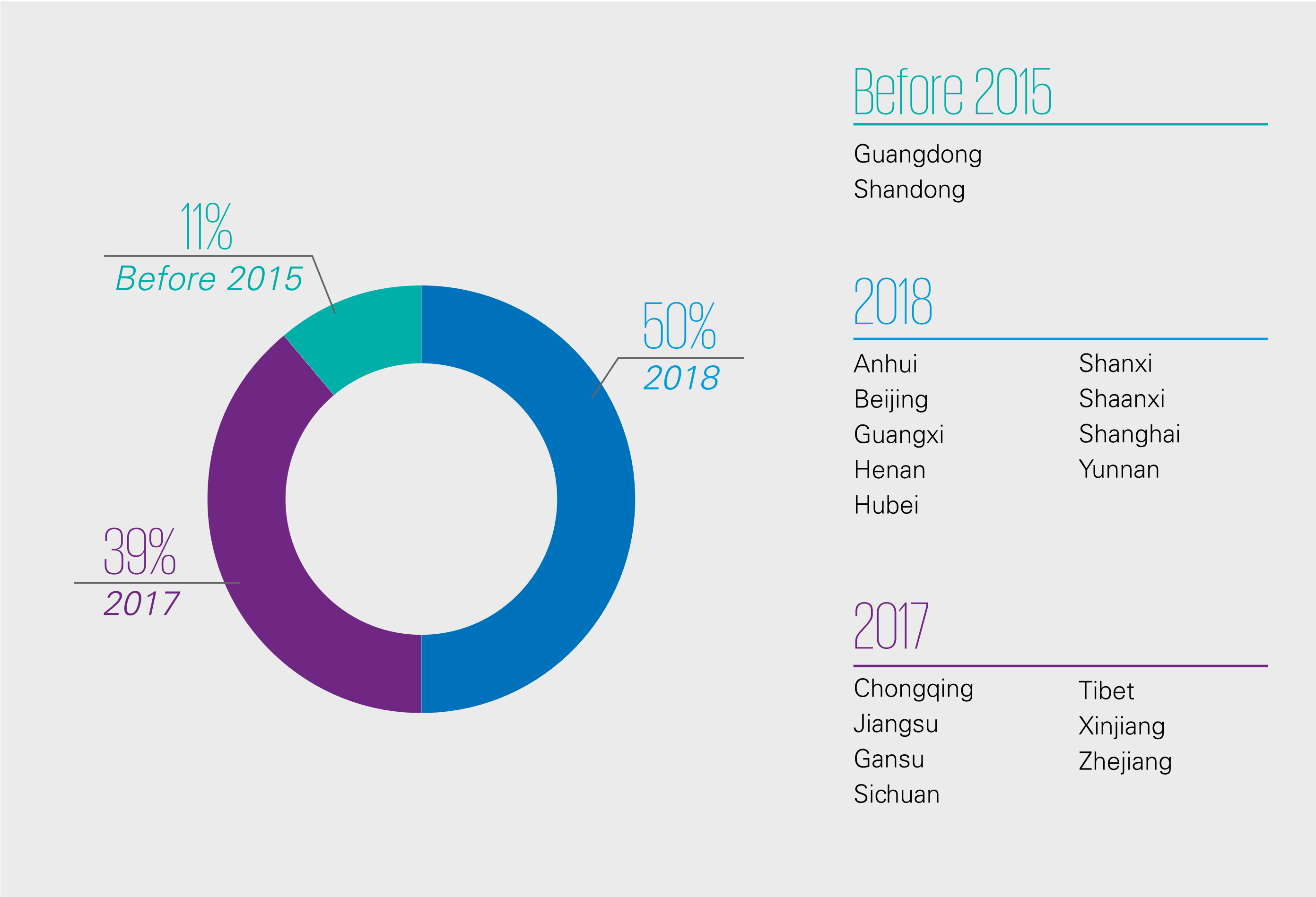
Surplus/deficit of public pension funds by province in 2018 (in RMB)

Province	Surplus/deficit
BEIJING	103.5bn
TIANJIN	6.0bn
NINGXIA	2.9bn
JIANGSU	52.2bn
SHANGHAI	22.5bn
CHONGQING	10.9bn
HAINAN	5.8bn

Source: National Bureau of Statistics

On the other hand, as part of the measures to combat their deteriorating financial status, more provinces have asked the National Council for Social Security Fund (NCSSF) to manage their investments, aiming for improved returns and better-managed risk. The number of provinces that have delegated investments to the NCSSF grew to 19 by the end of Q3 2019. Total mandated size also rose to RMB 966 billion, of which RMB 799.2 billion is funded. This programme started on a trial basis in 2011, with Guangdong and Shandong being the first two provinces to have worked with the NCSSF. In 2015, the State Council issued official guidelines, and the whole programme has seen rapid adoption on a national scale since then.

Provinces that have signed investment mandates with the NCSSF as of December 2018



Source: Ministry of Human Resources and Social Security (MoHRSS)

1.1.2 NCSSF

Given the worsening financial situation of provincial public pension funds, it is increasingly likely that the NCSSF will need to be prepared to fund some gaps earlier than expected. In the face of this challenge, the Fund continues to prepare itself in two ways. The first is to streamline the inflow by continuing to enlist share transfers from state-owned enterprises (SOEs). In July 2019, the State Council announced that the initiative to use state-owned shares to contribute to the NCSSF would be rolled out on a national basis within the year. Subsequently, the Ministry of Finance in September transferred to the Fund 10 percent of shares from some of the country's biggest listed companies, including China Life, Agricultural Bank of China, PICC and Bank of Communications. The NCSSF has so far seen three batches of state-owned share transfers, totalling RMB 660 billion.

- 1st batch: 2018, five companies
- 2nd batch: 2018, 15 companies
- 3rd batch: 2019, 35 companies

Listed companies that have announced share transfers to the NCSSF

Company	Announcement
China Unicom	Mar 2018
China Nonferrous Metal Mining Group	Mar 2018
Zhongnongfa Seed Industry Group	Nov 2018
China Huaneng Group	Nov 2018
PICC Group	Dec 2018
China Taiping	Jan 2019
China Re	Apr 2019
China Travel Service Group	Sep 2019
ICBC	Sep 2019
Agricultural Bank of China	Sep 2019
Bank of Communications	Sep 2019
China Life	Nov 2019

In parallel to institutionalising its inflow, the other measure the Fund has focused on is seeking higher returns from its investment portfolio. The Fund's asset allocation has remained stable in recent years, indicating that it is close to its long-term target. However, there are two indications that the Fund will continue to be active with portfolio adjustment. Firstly, the Fund reported a loss in 2018, possibly due to the A-share market's performance. While the Fund remains one of the best-performing long-term institutional asset owners in China, the loss is expected to drive the Fund to further diversify its assets. For its public equity portfolio, the Fund may also seek more sophisticated investment policies. Secondly, the continued capital injection, whether in the form of cash or listed companies' shares, means that the Fund will have to rebalance more frequently. It will also be managing a more sizeable portfolio, which allows it to use more external capacity. In any case, we expect the Fund to seek more exposure to new asset classes, new investment strategies, as well as to use more external managers.

In the longer term, despite the worsening financials, we expect that Pillar One will continue to be the largest and most important part of China's pension system. As society ages, more individuals will be drawing money from their pension accounts. The Public Pension Fund (PPF) and NCSSF combined already account for about half of the country's pension assets and have a much wider coverage than the other two pillars. The coverage and size make the PPF, and its reserve, the NCSSF, the most indispensable part of China's pension system. This means that various policymakers and administrations will have a strong incentive to make sure that Pillar One continues to function efficiently. As a result, it will likely develop most rapidly in relation to other pillars. Not only will Pillar One continue to enjoy the various special measures (including investment liberty, continued capital injection, national centralisation, professional management), some of the most beneficial reforms are also likely to be rolled out under Pillar One first, including management centralisation, streamlining of capital injection, overseas investments, as well as better selection and monitoring of external managers.

1.2 Pillar Two - Enterprise annuities and occupational annuities

1.2.1 EA

Enterprise annuities are expected to finish 2019 with more than RMB 1.7 trillion in total assets, representing growth of 19 percent year-on-year. Most of the growth came from capital appreciation, as the whole programme realised strong returns in the first half of the year, with a weighted average return of 4.1 percent owing to the A-share market's strong performance. By comparison, participation growth has been subdued. As of 2019 Q3, there are 93,422 enterprises that have set up their enterprise annuities plans and 25.06 million individual participants. This represents year-on-year growth of 6.9 percent and 4.9 percent, respectively, far below the asset growth. However, in the longer term, a much higher participation rate is essential to realise sustainable growth in the scheme. While lukewarm participation growth has historically been attributed to the high labour costs of small and medium-sized companies and insufficient tax incentives, we believe other factors have exacerbated the situation: a lack of customisation and personalisation, restrictions on investment, and low visibility on historical and expected returns. In addition, a lack of plan mobility means that enterprise annuities are less appealing to individuals who work at small and/or privately-owned companies, which typically see a higher turnover in personnel.

1.2.2 OA

By comparison, occupational annuities saw rapid development in 2019, as more provinces announced plans for OA launches, or awarded vendors actual mandates. While some of the most economically developed provinces have yet to create their own OA plans, there are multiple reasons for optimism about the scheme's short to medium-term prospects. Firstly, the OA plan benefits from its mandatory nature. This ensures high participation, better funding status and consistent long-term contributions. Secondly, the scheme also benefits from the fact that Ministry of Human Resources and Social Security (MoHRSS) acts as the gatekeeper and runs a centralised vendor selection programme. Thirdly, scope remains for the participation rate to further rise. For example, some retired government employees have expressed an interest in joining the scheme voluntarily.

Size of provinces' first mandates (in RMB)

BEIJING	SHANGHAI	NINGXIA
103.5bn	2.9bn	22.5bn

Provinces that have appointed a professional manager for OA plans

Anhui	Henan	Hubei	Hunan
Liaoning	Shandong	Shanxi	Xinjiang

Sources: PRC government and KPMG analysis

1.2.3 Accelerated opening up

Aside from the growth in assets and penetration, the biggest development in 2019 for Pillar Two was Chinese policymakers' decision to open up the pension industry sector to foreign players, as part of the opening up of the financial services industry. Pension management was named as one of the two sectors in China's financial services industry that will "encourage" foreign participation, in the 11 opening-up measures announced in 2017 and updated in March 2019. China Banking and Insurance Regulatory Commission (CBIRC) approved Heng An Standard Life, a joint-venture insurer between Aberdeen Standard Life and its Chinese partner, to launch a pension insurance subsidiary company. Once operational, it will be the second Sino-foreign joint-venture pension manager after China Life-AMP, and the first greenfield JV. While Heng An Standard Life is the first foreign applicant to be rewarded for its commitment to the sector, the pension market in China is big enough for more entrants, and Chinese policymakers and regulators are determined to attract more foreign players.

1.3 Pillar Three – Private pensions

Pillar Three registered the slowest growth during 2019, although the sector continues to attract some new entrants, both on the tax-deferred annuities plan side and the fund-of-funds mutual funds side.

1.3.1 Tax-deferred annuities

Compared with 2018, there was a clear cooling-off of interest in tax-deferred annuities products in 2019 with just one new tax-deferred annuity plan brought to the market, compared with 17 in 2018. This is partly because most of the large insurance companies that harbour ambitions in the pension space launched their offerings in 2018. It may also be due to the fact that other players are becoming more cautious about this opportunity, as the first round of products did not generate meaningful inflows.

Companies that launched tax-deferred annuities

Insurer	# of products
BoComm Life	2
CCB Principal Life	2
China Life	2
CITIC-Prudential Life	3
Generali China Life	2
Heng An Standard Life	3
ICBC-AXA Life	3
Mingshen Life	2
New China Pension	3
PICC Life	2
Ping An Pension	3
Sino Life	3
Soochow Life	2
Sun Life Everbright Life	3
Taikang Life	3
Taiping Life	2
Taiping Pension	2
Yingda Taihe Life	3
Total	**45**

1.3.2 Target-date fund of funds

There was a similar slowdown in the launch of target-date fund of funds, although fund management companies in general are showing more interest than their insurance peers, despite equally sluggish sales results. Some 34 fund management companies were offering a total of 59 funds at 2019 year-end. It is noteworthy that pension fund of funds offered by fund management companies still do not enjoy any tax benefits. With the track record and product awareness they have been building, there might be a revival of interest once such supporting measures are finally in place.

Pension products offered by fund management companies

Companies	Approval date of first fund	# of products to date
Harvest FMC	Aug 2018	2
Penghua FMC	Aug 2018	1
Zhong Ou FMC	Aug 2018	2
Wanjia FMC	Aug 2018	2
Huaxia FMC	Aug 2018	4
Fullgoal FMC	Aug 2018	1
Bosera FMC	Aug 2018	2
ICBC Credit Suisse FMC	Aug 2018	4
BOC FMC	Aug 2018	1
GF FMC	Aug 2018	4
Yinhua FMC	Aug 2018	4
E Fund FMC	Aug 2018	3
Southern FMC	Aug 2018	3
Manulife TEDA FMC	Aug 2018	2
Guotai FMC	Oct 2018	1
China Universal FMC	Oct 2018	3
Huaan FMC	Oct 2018	2
AEGON-Industrial FMC	Oct 2018	1
CCB Principal FMC	Oct 2018	1
GTJA Allianz FMC	Dec 2018	1
Bank of Communications Schroder FMC	Dec 2018	1
China International FMC	Dec 2018	2
Minsheng Royal FMC	Dec 2018	1
UBS SDIC FMC	Dec 2018	1

CIB FMC	Dec 2018	1
China Merchants FMC	Dec 2018	1
Chang Xin FMC	Dec 2018	1
Haifutong FMC	Dec 2018	1
Qianhai Kaiyuan FMC	Apr 2019	1
Invesco Great Wall FMC	Apr 2019	1
Tianhong FMC	Apr 2019	1
ABC-CA FMC	Apr 2019	1
Ping An FMC	Apr 2019	1
Dacheng FMC	Apr 2019	1
Total		**59**

1.3 Pillar Three - Incremental growth but big potential

Similar to the enterprise annuities scheme, the tax incentive provided for pension annuities products appears to have been insufficient for the scheme to take off, as none of the incumbent offerings have registered meaningful inflow. Experience from enterprise annuities products suggests that for a new scheme to reach critical mass, preferential tax treatment has to be combined with other incentives, including a stable investment return track record, investor education, detailed disclosure, long-term planning, an easy-to-use administration platform – preferably mobile – and regulatory oversight. That may be why fund managers continue to bring new pension products to the market. For them, having a live product allows them to build a track record, to occupy the distribution shelf and to keep stress-testing their operational integrity, all of which will be a crucial competitive edge when the market takes off.

Forecast

While China's pension system is expected to maintain its growth rate because it remains in its early stages, it will continue to experience rapid and often long-lasting changes. There are several important trends we expect to play out over the next one to three years.

2.1 Changing mindsets

The rapid proliferation of pension products, the rising profile of pensions in the media, and the diverging investment returns delivered by various pension products owing to liberalisation all help promote the awareness of pension arrangements among Chinese investors. As basic pension plans quickly approach 100 percent coverage, the narrative is being steered in two directions. On the one hand, investors are being reminded that the low replacement ratio means that even with 100 percent Pillar One coverage, most individuals will have to prepare supplementary pensions to maintain their lifestyle post-retirement. And on the other hand, as Pillar Three attracts new providers, retail customers are being constantly encouraged to participate in those voluntary pension plans. As a society, Chinese customers are at an inflection point where they realise they will need to take more personal responsibility for their pension plans. Their participation will bring profound changes to the industry. On the regulatory side, more stringent consumer protection regulations are expected to be put in place. Distributors, product manufacturers, and other contenders for Chinese retail's pension money are expected to upgrade their client onboarding process. These companies will also have to offer more personalised products and service modes to satisfy Chinese consumers. Lastly, a more robust infrastructure is needed to operationalise these changes and development, requiring more investment into process, people, and technology.

2.2 Increasing use of technologies

Several critical developments will need to take place in the industry to accommodate this change of mindset. In addition to the ones we have mentioned above, one critical element is financial advice. The shift from a pure government-sponsored pension system to a hybrid model means individual investors must take more responsibility for their financial affairs or risk not having enough resources for their retirement. This reinforces the need for competent and comprehensive financial advice, especially for the retail segment and the middle class. While banks, independent financial advisors and insurers have spared no effort to train their sales team to provide more financial advice around retirement planning, the sheer size of the challenge means that it will take the industry many years to fully meet all consumers' need for advice.

Thankfully, China's robust fintech industry has offered its own solution. With the rise of robo-advisor firms, Chinese consumers can get basic financial planning tools and education via various apps on their mobile phones. Integrated into day-to-day payment and social media, these apps now also offer their users basic retirement-related tools such as saving calculators, comparative information about various pension products and general advice on personal financial planning. Given that all the technology giants have announced their ambition to build a strong financial services business, it stands to reason that Chinese consumers can expect to benefit from their technology, a fresh approach and agility.

2.3 Intensifying competition

This leads to our last forecast for the coming year: the competition for the pension money of Chinese investors' – retail or institutional – will rapidly intensify. There are several factors contributing to this trend: firstly, there is expected to be a group of new entrants, including foreign pension players, domestic insurers and asset managers, as well as technology companies. Secondly, within the industry, regulatory development will drive competition around product design, market access, investment capabilities and risk management. Lastly, higher levels of retail participation mean a pensions market that will be more dynamic, exerting more competitive pressure on all incumbent players.

For foreign players, China's pension management market is one of the last few greenfields in China's financial services industry, and its allure is of global importance. However, several idiosyncrasies of the China market also mean that it will be a tough challenge. China's pension system is regulated under a multi-agency framework. The nascent nature of the industry also means that much of the required infrastructure will have to be built from scratch. All service providers are expected to build an infrastructure locally that is rigorous enough to serve a vast number of individuals, and they will need to make sure that their global governance model is compatible with certain features of the new architecture.

For domestic players, the core capabilities required to manage the multiple asset classes needed in any pension product may be obtained quickly as long as sufficient financial resources are deployed. However, the risk culture, market access and technology infrastructure to administer the pension system as a whole can only be acquired over time.

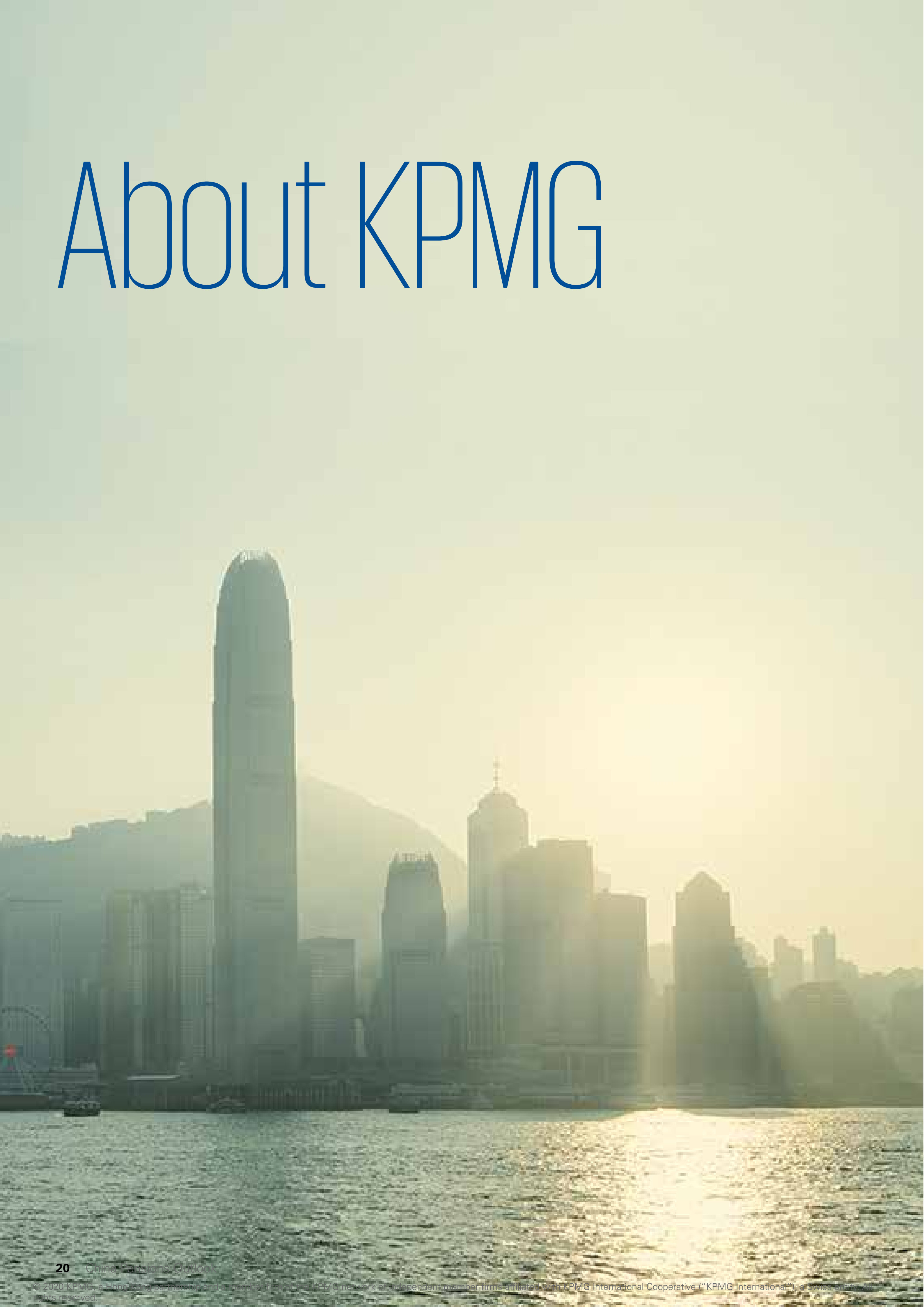
Additionally, building a pensions business from the ground up will require dedicated resources. The fact that the business will remain marginal, if not loss-making, in the short to medium term means that a more strategic approach is required. With the possible exception of some fund management companies, many domestic firms currently still hoard licences in their pension business. As a result, there is limited engagement with retail investors, a lack of focus on the investment required to build a one-stop solution, and inadequate exposure to certain asset classes required for pension fund management.

Lastly, building a relationship that is more advisory than transactional with retail consumers might be another challenge for both product manufacturers and distributors. While Chinese distributors are very effective at mobilising a large client base and registering impressive sales figures, forging a relationship with mass retail clients that is characterised by trust will require them to step out of their comfort zone. And yet this kind of relationship is exactly what it takes to foster the sustainable growth of the pension industry as well as individual investors' financial security.

Summary

In 2019 China's pension market continued to be at the forefront of the modernisation of its financial services industry. Various indicators suggest healthy growth prospects, improving investment returns, growing participation and diversity. Some of the fundamental developments, including opening up to foreign entrants, additional use of professional managers, and the beginnings of a centralised operating model, give hope for sustained longer-term development. On the other hand, the industry has yet to break away from some chronic issues. Furthermore, new challenges mean all stakeholders must rethink their strategy. As a sustainable pension system is built with the collective effort of government, employers, providers and individuals, we expect Chinese retail customers to take a more proactive role in managing their pension money. Pension managers will need to be ready to meet their unique demands.

About KPMG



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