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THE SOCIAL INSURANCE LAW OF PEOPLES' REPUBLIC OF CHINA—PART II

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Editor's Note: This is Part 2 of a summary of new, upcoming Social Insurance Law in China. Part 1 was presented in the July 2011 issue to heighten your awareness of what's happening in China so that you may be attuned to news articles as they emerge. Part 2 continues that story.

BACKGROUND OF CURRENT SOCIAL INSURANCE SCHEMES IN CHINA

The social pension plan in China began in the 1990s as a state policy to facilitate restructuring of the once-inefficient state-owned enterprises system in China as a consequence of open market economic reform in the 1980s, and as a method at that time to absorb a significant portion of layoffs and transfer the existing retirement burden from state-owned enterprises to a general social pooling without significant considerations from state-owned enterprises undergoing the restructure. While some industry-intensive regions, such as Shanghai and Beijing, began their pilot plan in the early 1990s, a nationwide uniform policy regarding social pension plans was established by the State Council in 1997, which required establishment of a hybrid type of pension plan with two standings: the social pooling and an individual account (IA). Both social pooling and IAs are in fact controlled and managed by governmental administration, and some of the funding was attributed to participants through the IA, which is credited with a bank deposit interest rate annually. But the funding into IAs is actually used in its entirety to pay current retirees' benefits, and led to the social pension plan being run as a pay-as-you-go (PAYGO) system in essence until 2005, when a new state policy focusing on reform of the social pension scheme came into existence. The State Council enacted a revised social pension scheme in 2005 to address the IA loophole issue by reducing

CONTINUED ON PAGE 3

the attribution rate to IA thereafter, requiring no further use of IA funding to support current retirement benefit payments, and a phase-in filling plan on IA loopholes, but without any timetable imposed. So far, only 13 of all 31 provinces have chosen to enforce the 2005 scheme, whose difference from 1997 scheme has been tabulated as follows.

As a summary, the public pension scheme in China has the following characteristics.

1. A predominating social pension program.

The current public pension scheme is purposed to provide a floor of protection to retirees. Consequently, the expected replacement ratio under the 2005 scheme for most of the population is below 50 percent, and they will need further financial arrangement for their retirement. No formal incentive policy for individual retirement saving has been made so far. And employer-sponsored plans have been still in their infancy in terms of a small size, as a result of the absence of tax incentive policy, the already high matching contribution burden on employers in the mandatory plan, and high operational costs for medium and small employers. In response to this situation, the Ministry of Human Resources and Social Security (MOHRSS), the charging regulator of private pensions, publicized a set of detailed rules to facilitate establishment of multiple employer-sponsored plans in February 2011.

Table 1. Comparison Between 1997 Scheme and 2005 Scheme for New Participants

	1997 Scheme	2005 Scheme
Contribution Attributed to IA	All 8% (of salary basis) contribution from individual participant; 3% from 22%* matching contribution by employer Total: 11%.	All 8% contribution from each participant. Total: 8%.
Monthly Benefit Calculation	Basic Benefit supported by social pooling, 20% of average salary of all workforces in last year. Plus IA end value/120.	Basic Benefit supported by social pooling, 1% for each year of contribution record or credited service. Entitlement of Basic Benefit begins after at least 15 years' credited service and/or contribution record. The calculation basis is an average between indexed contribution basis over entire work life and average salary of all workforces. *Plus* IA end value/an actuarial amortization value (expected to vary over time).
Participation	Voluntary for self-employment or flexible employment.	Mandatory for all types of employment.

*Varying among different regions and over time.

Table 2. Expected Replacement Ratio for the Average Person in Different Classes of Population under Urban Employee Public Pension Plan

Group	Basic Benefit	IA Benefit	Total
Lowest Income	40.00%	16.09%	56.09%
Lower Income	33.33%	13.41%	46.74%
Low Income	28.13%	13.41%	41.54%
Median Income	25.00%	13.41%	38.41%
High Income	20.83%	13.41%	34.24%
Higher Income	16.67%	13.41%	30.08%
Highest Income	10.00%	8.05%	18.05%
Civil Servants and Public Employees Within Middle Class	Not Applicable		88%**

*Assuming 25 years' contribution payment record, 6.5% salary increase annually, 2% credited rate with IA.
** A target replacement ratio for this class is established by governmental policy.

CONTINUED ON PAGE 4

2. Segmentation.

Until 2009, the majority of public pension schemes were a city-level or county-level plan, all of which were then unified into a provincial-level scheme respectively without a clear timetable of further unification into a nation-wide plan. Additionally, different classes of the population have been covered by different plans, where both contribution requirement and benefit level vary significantly. As you can see as an example from Table 2, civil servants and public employees are covered under a separate public pension plan, which doesn't need a matching contribution from the government as the employer, but are provided a higher target replacement ratio. Until the introduction of the Social Insurance Law in July 2011, employees working in urban areas but from rural areas are covered by a separate public pension plan in most regions, where the contribution and benefit are usually significantly lower than for their peers from urban areas. Certain efforts have been made to unify different plans to a degree of at least minimizing unintended consequences. Historically, different provinces adopted different scheme parameters and made transfers between different plans extremely difficult. The State Council has published a new set of detailed rules to allow and permit transfers between different plans under due causes in 2010.

Table 3. Realized Coverage Ratio for Each Target Population Classes as of the End of 2009

Classes	Urban Workforce Pension Scheme	Urban Workforce Medical	Urban Workforce Workers' Compensation	Residence Basic Medical	Residence Basic Pension
Urban Workforce	57.01%	38.80%	40.51%	Not Applicable	
Urban Workforce from Rural Area	13.56%	18.87%	24.31%	Not Applicable	
Urban Residence	Not Applicable			44.67%	Not Applicable
Rural Farmer	Not Applicable			94%**	21.27%

* As of the end of 2009, no formal residence pension plan for urban areas was in existence.

** An official number on the participating rate without sufficient details. An in-depth case study in a small-sized sample showed a significantly different picture.

3. Undesirable coverage outcome.

The realized coverage ratio for each target population varies significantly, and is generally far from complete coverage (as you can see from Table 3).

The coverage amount for each plan also varies significantly, and has been implying a significant lack of coordination in coverage and benefit amount; i.e., the national level benefit set for the urban residence pension plan is RMB 55 Yuan per month, which may be increased by the local government, but is still significantly lower than a minimum living standard will require. Significant variation between different public pension plans makes them further difficult to coordinate.

4. Unfunded accumulated benefit.

The 1997 plan was totally established from the ground without any funding for all accumulated benefits, and then the plan has been operated as PAYGO system in essence with a nominal IA for each participant. The estimate of unfunded accumulated benefit varies with assumptions. An official estimate made in 2000 is restricted to release; but, as a consequence, a new administration, the National Council for Social Security Fund, was established to manage a national wide assets pool supporting social insurance programs. (See table 4, pg.5)

Table 4. Unfunded Accumulated Benefit Analysis as of the End of 2000 (in Billions RMB)

All Existing Retirees	Basic Benefit with Regard to Service Years before 1993	Benefit with Regard to IA from Service Years before 1993	Used-up IA Funding Since 1993	Total	% to GDP
620	1068	534	94	2316	25.91%

*Source: Wang Wenliang (2011).

5. Nominal individual account.
So far, only 13 provinces have undertaken the 2005 scheme to solidify the IA thereafter, with a total accumulative assets value in all IAs of RMB 203.9 billion. Other provinces lacked the governmental revenue resources to solidify the IAs. Despite the 2005 scheme, no province so far has a formal fiscal arrangement to cure the IA loopholes incurring prior to the 2005 scheme.

6. Less efficiency of investment management.
A nationwide administrator, the National Council for Social Security Fund, was established in 2001 to manage a nation-level pension fund from social pooling as appointed manager and to manage local-level pension funds from both social pooling and IA as an agent. By the end of 2010, its assets under management (AUM) size was RMB 865 billion, which resulted in a total equity of RMB 838 billion, including an amount of RMB 57 billion equity attributed to IAs. The annual nominal return rate for the overall portfolio has been in a range of 2 to 4.5 percent. The annual credit rate to IAs has been officially set at the same level of a bank deposit interest rate prevailing at the time of crediting. In addition, the funding accumulation in social pooling and IAs is solely controlled by the governmental body and has been undergoing a rigid investment assets universe. Serious concern about inadequate and inefficient investment return in light of the inevitable high inflation rate over a long-term horizon has been arising and challenging the policymakers.

7. Aging issues.
The birth boom generation after the Revolution War in China (1949) has already produced a significant burden on public pension plans since 2000, when the female population from this generation began to step into the retiree population after they met the mandatory retirement age of 50. The male population from this generation began to join the retiree team in 2010, when they met the mandatory retirement age. Additionally, many early retirement privileges were generously granted to participants in the 1990s to facilitate layoff arrangements from restructuring inefficient stated-owned enterprises system. Consequently, the dependent ratio in China will increase significantly to reflect those historical events. The Birth Control policy, One Family One Child, adopted in the early 1980s, will further aggravate the dependent ratio starting in 2030 as expected.

The current dependent ratio has been tabulated as follows. (Table 5, pg. 6)

COMMENTS

1. Separate treatment of the population and its implications in the long term will need to be well conceived.
Separate treatment of the population by providing different plans to its target populations

Table 5. Dependent Ratios Over Time in China

Year	Age 60+ as a % of Total Population	Age 65+ as a % of Total Population	Realized Dependent Ratio for Urban Area Public Pension Plan	Realized Dependent Ratio for Rural Area Pension Plan	Overall Dependent Ratio for Entire Population **
2010	13.26%	8.87%	32.50%	38.62%	22.21%
2005	11.03%	7.69%	33.29%	Not Applicable	18.50%
2000*	10.27%	6.96%	33%		18.27%

* Year 2000 is the first year that China can be categorized as an aging country according to the UN standard.

** Age 60+/ active workforce.

will produce some significantly undesirable consequences that will need to be addressed appropriately in the future. The undesirable consequences include, among others:

a. The target replacement ratios for civil servants, public employees and urban employees are significantly different as you can see from Table 2, where the median-income, high-income and higher-income classes are the most financially disadvantaged populations yet the majority of current middle income groups in our society. Those populations aren't rich enough and have limited alternative financial resources to secure their retirement. Consequently, if the current pension plan does achieve its policy objective, the downsizing of the middle-income group in future society and the widening of the financial gap between public employee retirees and enterprise employee retirees groups and between different income classes will be most likely to result and perhaps jeopardize society by causing instability.

b. A lesser degree of coordination will generally lead to a higher cost implicit in future unification. It's more likely than not that any benefit gap between current different plans will push up costs when a low-level plan will need to be integrated into a high-benefit-level plan.

c. Competition from the urban employee plan to include those employees from rural areas will help stabilize the dependent ratio in such urban plans to a certain level yet aggravate the rural area pension plans by draining a young and productive population from the rural area. From Table 5, you can see that the urban plan has already reduced its dependent ratio slightly at the same time the rural area has a higher dependent ratio, which is in contrast to the intuition that the family size is usually larger and a family has more young members in a rural area.

d. The gap between different plans, uncertainty of the plans' eventual fortune, and not fitting well into the real financial needs of the target population, all contributed to a "lack of incentive to participate" result, a lower participant rate realized as you can see from Table 3. (See pg. 4)

e. Anti-selection is a major concern when the participant can choose among different plans or different places to participate.

Had not the foregoing been appropriately addressed, we could expect that the migration population from rural areas to urban areas during the urbanization process, estimated as 260 million within the forthcoming 30 years, would be adversely impacted in their financial position or would produce an unaffordable cost on social security. Additionally, the financial conditions with regard to social security in rural areas would be deteriorating relative to urban areas in the future as a result. At the same time, we may experience a shrinking middle-income class in our society as well.

2. Funding issues with regard to historical liabilities require more actions beyond commitment in law.

The new Social Insurance Law has ruled that the government shall be responsible for all contribution obligations with regard to credit service years earned by all participants prior to 1993 as employees in old state-owned enterprises. Nevertheless, this ever first clarification of policy is only as sound as to express the willingness to rear-fund the social insurance pooling. Without details of how to calculate contributions and how to allocate such burdens across different levels of the government ladder, contribution injection in rear by itself may not fully reflect the salary level difference, realized investment returns with regard to both social pooling and IA of those affected, change in mortality, target replacement ratio, and attribution rate over time. An actuarial equivalent value of accumulated benefit at time of rear-funding is more appropriate, but rear-funding in full is neither economically desirable nor fiscally feasible.

3. The role of the government on funding of the social insurance plan shall be reconsidered.

The prevailing role of government on social insurance plans, including commitment to subsidy and budget balance on current gap, rear-funding historical liability, and management of funding on both social pooling and IAs, shall be reconsidered to address the emerging experience.

a. Management of IAs by the government is only efficient if the government body provides a return guarantee and the government body can use the funding as a loan to them. The embedded value from an extremely lower guarantee rate over a long term is less valuable particularly when it won't provide adequate real value protection as demanded. The IA can be operated in a more efficient way if the private participant has some kind of control on the account and can be responsible for the outcome from his own decisions if it is not desirable for the government to provide a real value protection guarantee.
b. Improvement on the current rear-funding plan, through a more clear and consistent approach, structure and timetable, along with a set of lock-in fiscal sources in advance, will benefit by avoiding conflicting fiscal and financial policy over time, achieving the public's greater confidence on future funding status, and providing smoother annual budgeting.
c. The central government shall undertake an arrangement to help local governments to establish some necessary reserves to balance future increases in the size of subsidies due to the local government having a weaker revenue-generating capacity than the central government under current tax and fiscal regimes.

4. Improvement of transparency on operation, funding and the contribution decision-making process is needed.

As a general proposal, we call for a more transparent operation of public pensions for civil servants and public employees (which are currently restricted from disclosure), for enterprise employees and residences, through fair, adequate and timely disclosure, a sound governance and efficient surveillance. The general public's interest can be better served through the active participation by due delegates from

CONTINUED ON PAGE 8

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the public into the management, operation and decision-making process of social security programs and social security funds within and beyond the legislature channel.

5. Unsustainable factors and incentives exist in the current program.

The urban employee basic medical plan will be unsustainable under current plan parameters despite the accumulative value of the medical plan's social pooling being still high now.

a. The current plan provides a strong incentive to retiree beneficiaries to overuse the public medical plan, through no need to pay premiums after retirement, an annual IA filling, a low deduction level and/or co-share requirement, and a generous ceiling.

b. The IA may provide some buffer in the loss corridor before entering a higher accumulative claim band, but the assets in the IA are ultimately the personal assets of the individual participant who may behave in a way contrasting to what is expected by the plan manager.

c. Too much extensive coverage of medical services has been provided to all covered, and reduction of coverage will receive strong resistance.

d. The per member per month (PMPM) rate has already been high as 2 percent from employees and a matching 12 percent from employers against salary basis in some regions; the room for further increase is very limited.

e. The participating rate will continue to be low due to the difficulty in using the medical plan outside its primary operation region, which means the general accessibility of plan service is low, where no hope of a nationwide uniform medical plan will be in existence.

f. The current pension plan transfer policy doesn't financially support a medical plan for that population in migration.

6. Residence pension plans will have to be coordinated with the existing minimum living maintenance subsidiary plan using means-testing method.

The residence pension plan for urban areas is expected to experience a shrinking participation due to fact that the urban family after the Revolution War is usually a two-worker family and the plan is targeted to cover those already aged rather than attracting young participants. The residence pension plan for rural areas is targeted to provide coverage on those already aged and to attract young farmer work to participate to support in funding, and it is also expected to experience a shrinking participating population due to urbanization. In consideration of the inadequate size of the residence plan in certain developed regions and inadequate participating population on its own in most regions in the future, the Social Insurance Law permits the two residence pension plans to run altogether if the provincial government chooses so. Nevertheless, those entitled under residence pension plans are usually covered by the other official insurance program—Minimum Living Maintenance Subsidiary Plan (MLMSP). The MLMSP requires a means-testing method, but provides a higher benefit (without any premium payment) than from residence pensions (with a premium payment requirement for participants, but not entitled retirees). The overlapping may produce the result of reducing MLMSP population or MLMSP amounts or both, and may lead to resistance or anti-selection feedback from entitled beneficiaries. The coordination will be a major concern in practice for residence pension plans and calls for a careful solution.

7. Integration issues of the national social insurance pool and provincial-level social insurance pools need to be carefully addressed.

The new Social Insurance Law permits that the public pension plan for rural residence and urban residence may be unified at the discretion of the provincial government, and all public pension plans shall be unified across the nation eventually but without any timetable given, and other public plans shall be unified into a provincial-level plan but without any timetable given. Integration can be achieved from either transfer, phase-in or out, or separate calculation and aggregate payment, or some combination. The inter-province transfer policy effective as of the end of last year for urban employees' pension plan will favor the transferring province rather than transfer acceptance province, and will aggravate the government budget in certain areas within a real world of imbalance of regional development and revenue resources between provinces. Separate calculation and aggregate payment are a time-path-neutral and local-neutral method in nature and can be a more appropriate and cost-minimizing interim method in the process toward a nationwide uniform public pension scheme in the future. The same proposal can be made for integrating the residence pension plan with the current urban employee pension plan into a general pension plan. A phase-in implementing plan for those areas previously undertaking a lower benefit level employee pension plan for workers from rural areas will be more feasible in practice for them to eventually repeal this type of plan and put them on the same footing of urban employee pension plans for urban workers.

8. Encourage participation by insurance market.

The new Social Insurance Law has ruled that the government shall undertake to adopt tax incentive plans to support social insurance programs. We further urge a larger degree of participation by the insurance market through permitting of qualified private plans, coordination of public plans with private plans, and separation of risk pooling and taking between public plans and private plans. A good alternative with regard to worker compensation plans involves that the plan can be run primarily on a private-plan basis with benefits set forth by law and regulations, and the government can maintain a residual risk pool or sharing mechanism and operate an efficient regulatory system, as we can learn from other developed markets' experience. Such hybrid plans will benefit by making more competitive choices available, by establishment and expansion of related employer liability and professional liability markets, by more appropriate pricing, by more responsiveness to changing economic and social trends and risk characteristics, and by lower operational costs and feeding in more incentive for risk control.

While the new Social Insurance Law cannot be the sole basis to rely upon, it shall serve as a clear framework and a good beginning. If we address the identified issues and emerging experience appropriately, we will hopefully improve the incentive to participate from the majority of our society members, which is also the key to any successful social insurance program.

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