Stan Feng, ASA, leads Mercer's Retirement, Risk & Finance business in Beijing, China. He can be reached at *stan.feng@mercer.com.*

Expatriate Localization: A Chinese Solution

By Stan Feng

Editor's Note: This article first appeared in Mercer's Global Retirement Perspective at http://www.mercer.com/globalretirement *in early 2009. It has been reprinted here with permission.*

China has experienced significant economic growth over the last 30 years, during which its economy has grown faster than that of any other country in history. Foreign investments have been one of the major driving forces behind the explosive growth. These investments can be chronologically divided into three stages. During the 1980s, foreign investments were small and restricted to export-oriented joint ventures with local Chinese firms. In the 1990s, foreign companies were allowed to establish wholly owned foreign enterprises and manufacture goods for sale in the domestic Chinese market. Since 2001, when China entered the World Trade Organization (WTO), more foreign investments have flowed in, particularly to the industries that were previously restricted, such as financial services, automotive and telecommunications. Today, over 90 percent of the Fortune Global 500 companies have made investments in China.

As multinational companies (MNCs) have increased their investments in China, the number of foreign workers in China has increased. In particular, with a shortage of local talent in China, particularly at the middle- to senior-management level, many multinationals have been using expatriates to fill key positions. Based on government statistics, the number of foreign workers in China more than doubled between 2003 and 2006, and as of the end of 2008, the total number of foreign workers with working permits (including Hong Kong or Taiwan residents) was more than 300,000.

Foreign workers in China can be categorized into the following groups:

- Expatriates from Western countries: hired in North America or Europe and transferred to China

- Expatriates from other Asia Pacific countries: hired within Asia Pacific but outside Greater China and transferred to China

- Expatriates from Hong Kong or Taiwan: hired in Hong Kong or Taiwan and transferred to China

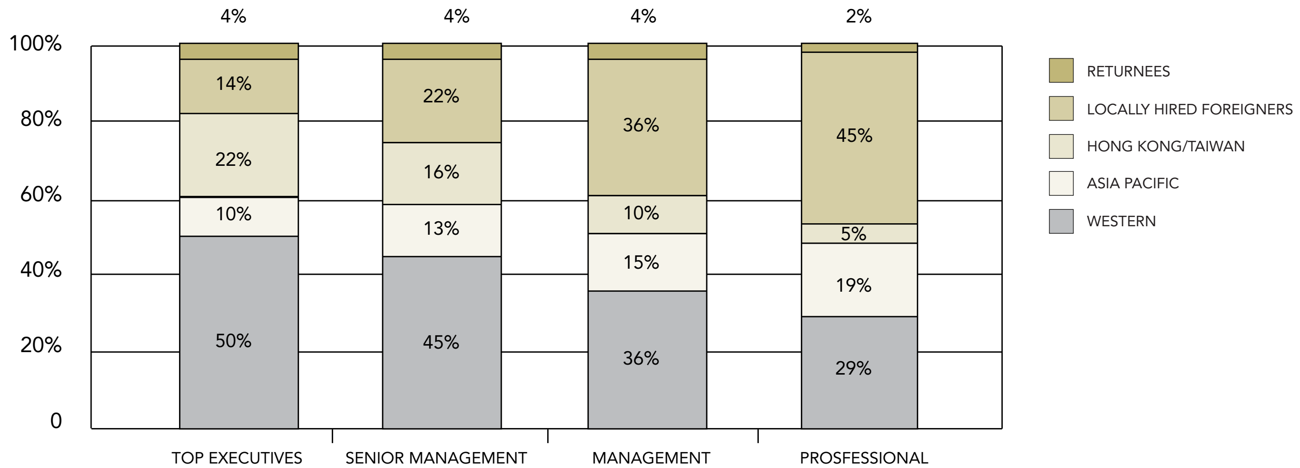
- Locally hired foreigners: hired directly in or transferred to China with a package different from that of expatriates and local employees

- Locally hired Chinese returnees: holders of Chinese passports with a foreign residency/green cards and hired in China

Based on Mercer's latest survey, the profiles of the foreign workers are summarized in the chart on page 53.

> "Local market practice and products are still developing, and there is no one-size-fits-all approach. Companies have to analyze their own situations to design appropriate solutions"

Profile of Foreign Worker (by Positions) in China



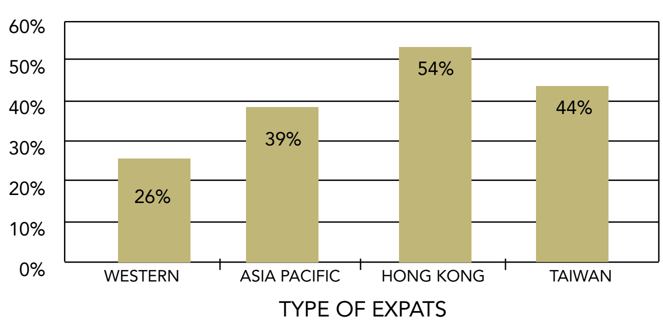
Source: 2008 Mercer China Expatriate Survey

THE TREND OF EXPATRIATE LOCALIZATION

China's economic growth provides opportunities for these foreign workers to grow professionally. This, coupled with improved living conditions in major cities in China, has resulted in many expatriates extending their assignments. As the total cost of an expatriate package is easily 50 to 200 percent higher than that of a locally hired foreigner, we have observed an increasing trend among MNCs to review their expatriate arrangements and look for more efficient ways to deliver the compensation and benefits by taking advantage of the ever-growing range of alternatives available locally.

Based on Mercer's 2008 expatriate survey, managing expatriation costs and localization are among the top issues of surveyed participants for all categories of expatriates. According to the survey (see chart below), 26 percent of companies will consider localizing expats from western countries, and as many as 54 percent of companies will consider localizing expats from Hong Kong.

Companies Considering Localization in China



CONTINUED ON PAGE 54

Expatriate Localization … | from Page 53

With the economic downturn that began last year, there has been even more pressure on companies to take actions to reduce costs through localizing expatriate packages. A Mercer survey conducted in February 2009 found that 57 percent of surveyed Asia Pacific participants are considering localizing expatriate packages (where possible), an increase from 39 percent a year ago, and 33 percent of surveyed Asia Pacific participants are considering a reduction of expatriate allowances and perquisites.

With an increasing focus on cost containment and finding local solutions, it has become more important than ever for MNCs to understand the benefit variation among different segments of foreign workforces; prevalent market practices; tax rules; locally available health benefit options; and retirement and savings options.

THE RETIREMENT BENEFIT

While considering localizing the expatriate package, elements such as cash, allowances and risk benefits (such as health care and insurance) are relatively easy to replicate; however, retirement benefits present greater challenges.

Expatriates working in China are typically put on a home country payroll and covered by the home country social security and retirement plans. When companies localize expatriates, they typically move them to a local payroll. Often the home country regulations or retirement plan rules make retention in a home country retirement plan impossible for a localized China-based employee. Some companies overcome this by administering a split-payroll arrangement in order to keep the localized expatriate on the home country retirement arrangement, but the cost and administrative complexity can be high.

In China, foreigners are generally excluded from the statutory social security system. In addition, while there is growth in the newly introduced company-sponsored retirement plan "Enterprise Annuity (EA)," the coverage of foreigners is not specifically allowed by the regulations. This makes the inclusion of expatriates in the local arrangement difficult. In addition, with tax rules applied differently between Chinese citizens and foreigners in China, and the statutory restrictions of foreigners participating in the investment savings products, offering retirement and savings arrangements in China can be tricky.

So what are the options available to MNCs? Generally there are four broad solutions:

1. *Cash Pension Allowance*—Instead of offering a formal pension plan for employees, the employer provides a cash allowance, paid along with salary.

2. *Book Reserve Plan*—A non-funded plan is provided and benefits payment is deferred until termination or retirement.

3. *Onshore Pension Plan (non EA)* —The employer covers employees through a pension product offered by a licensed provider. Typically, the products are offered by the insurance and trust companies.

4. *Offshore Pension Plan*—The employer covers the expats' pension provision by including them in an offshore pension plan. Examples of offshore coverage may include a Hong Kong plan, a global third country pension plan or a regional arrangement.

The following table summarizes some of the key features of the approaches on pg 54.

	Cash allowance	Book reserve	Onshore plan	Offshore plan
Tax effectiveness	Employer: pre-tax deduction Employee: immediate individual income tax (IIT)	Employer: tax deductible at payment Employee: IIT deferred to payment	Employer: might be deductible Employee: IIT at contribution or vesting	Employer: likely not tax deductible Employee: likely IIT at contribution
Investment & products	N/A	N/A; notional interest might be credited	Limited to China capital market and less sophisticated products	Access to international capital markets and sophisticated products
Flexibility	Very flexible	High degree of design flexibility	Less flexible (generally DC)	Design will depend on number of members covered and service provider
Costs	None	Soft costs related to plan management	In line with market charges	Can be expensive – depends on the size and the type of offshore arrangements
Administration	None	Usually self-administered, can become complicated with complex designs.	Administration usually bundled with pension provider, level of service in line with market maturity	Administration usually bundled with pension provider, but foreign exchange remittance for contributions and domicile of contracts can be challenging.
Ease of implementation	Good *	Good	Typically not an issue as there is no need to file the plan with any regulatory body	Nature of the product may require the involvement of legal, finance, and HR departments; expect lengthy implementation process.

*Although cash is the easiest to implement, it may be difficult to eliminate it if an actual plan is implemented in the future. So a company should specifically state that this is a cash allowance in lieu of a retirement plan.

CONTINUED ON PAGE 56

Expatriate Localization … | from Page 55

FINDING THE RIGHT SOLUTION FOR YOU

Expatriate localization is an emerging trend in China. Local market practice and products are still developing, and there is no one-size-fits-all approach. Companies have to analyze their own situations to design appropriate solutions. Companies need to consider:

- **Demographics**. What is the profile of your expat population in terms of size, position, age, nationality, residency, and salary, among other factors?
- **Internal company considerations**. In what stage of development is your company in China? What are your tax and HR philosophies (for example, internal equity across various employee groups)? Is it possible to retain expats in the home country pension plan and social security system, or do local plans exist that are more appropriate?
- **External market considerations**. What are the common pension benefits provided by other companies for expats at different levels? Are the expats under labor contracts or prior pension agreements?

Any of the above considerations alone may not dictate what type of retirement provision to offer, but they will serve as a useful reference to search for the best solution. For example, the higher the number of expats who need to be localized, irrespective of their positions, the more likely a company will offer a noncash retirement and savings provision. If a company has only a small number of expats in China, but has expats spread across other Asian countries without pension coverage and regional mobility is high, an offshore regional retirement and savings solution may be the best solution.
With the rapidly changing regulations and new product developments, solutions can be found that balance the cost and the needs of the company and its expatriates. □