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Employer Sponsored Plan in China—Reality, Issues and Policy Advice

By Wenliang Wang

This paper is a quick response to the new regulation set recently by four regulators in China for Employer Sponsored Plans: the Ministry of Human Resources and Social Security, the China Banking Regulatory Commission, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission. The new regulation, The Administrative Measures on Enterprise Annuity Fund, came into force on May 1, 2011 and replaced the 2004 edition thereafter. The opinions hereunder are derived partially from experience and from a comparison with advanced markets, such as North America, and can also serve as a comparison study from the perspective of practitioners in North America.

BACKGROUND

A voluntary employer sponsored plan system was first introduced into China by the breakthrough regulation, The Trial Measures on Enterprise Annuity Fund, set by the four regulators in February of 2004, in anticipation that a new national public pension scheme would come into force in 2005. The enterprise pension system is purposed to add another reliable and significant funding resource for employees in private sectors, after considering that the employees within the middle income class in the private sector was then expected to achieve a 52 percent replacement ratio after retirement against 90 percent replacement ratio for those in public organizations and 93 percent for civil servants, where a significant difference was perceived. The incoming 2005 scheme was then expected to aggravate this difference further by various efforts to reduce the benefit level in the 2005 scheme. Consequently, the breakthrough regulation set a firm official standing upon employer sponsored plan practices which had been in the real world for more than a decade under a non-regulatory context in China.

The market didn't react quickly and favorably to the introduction of the enterprise pension system, and the ministry in charge had taken a long time in formulating implementation details with regard to licensing qualified practitioners and market players. The first official license to an Employer Sponsored Plan came into reality in 2006, a year later.

By the end of 2005, China had a total amount of assets under Employer Sponsored Plans of 68 billion Yuan, 24,000 sponsoring enterprises, and nine million participating employees. By the end of 2010, China had a total amount of assets under Employer Sponsored Plans of 291 billion Yuan, 37,000 sponsoring enterprises, and 13.35 million participating employees. Over the last five years, the assets under plan (AUP) has achieved an annualized growth rate of 33.75 percent, despite that fact that the participating population is an extremely small portion of the total workforce (650 million at the end of 2009 by public statistics, estimated 656 million at the end of 2010) in the private sector, approximately two percent. The AUP for Employer Sponsored Plans is also very small when compared to the total capitalization of capital markets in China, approximately one percent, while our American counterpart was a ratio of 61 percent by the end of the third quarter of 2010.

Currently, an Employer Sponsored Plan can be operated by only a licensed trustee, which can take a form of either an Enterprise Annuity

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Council, a non-profit organization controlled by one employer and its participating employees, or a financial institution in the market as the independent service provider. Enterprise Annuity Councils had been the dominating form before 2005, and continue to prevail in the market, while market service providers as a qualified trustee by various type of financial institution has a less than a 50 percent market share in AUP. There are 12 market providers licensed as trustees competing in the Chinese market: four public trust companies, three commercial banks, and five

Table 1
Pension Companies' Market Share Analysis

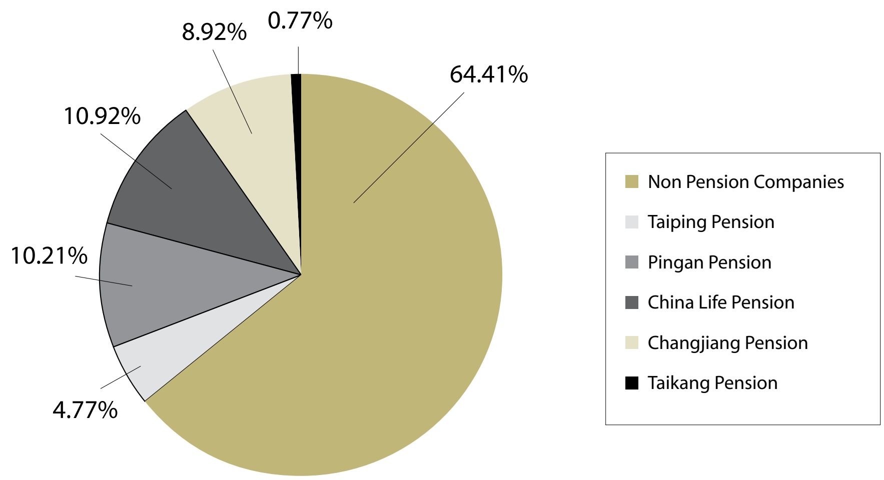
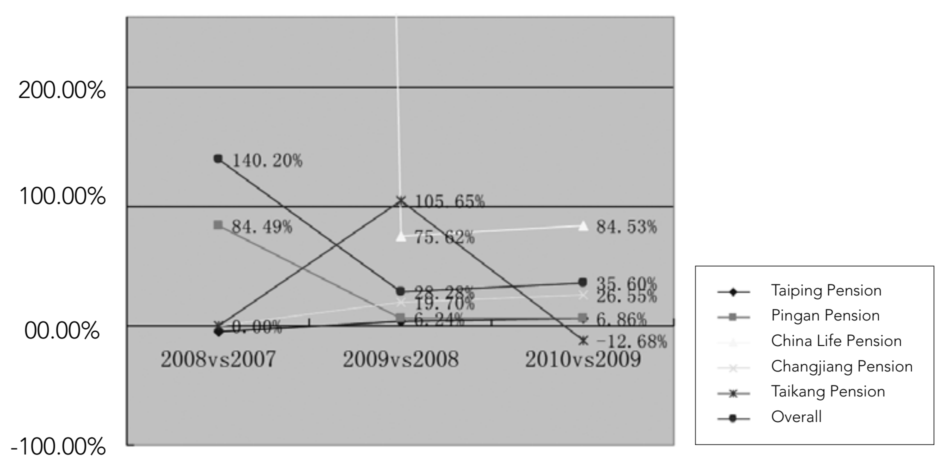


Table 2 series-A
Annual Growth Rate for Contribution Received



pension companies (usually affiliates of major insurance companies in China). The market shares of those five pension companies by the end of 2010 in terms of Assets under Plan are given in Table 1, while the business growth rate of those five pension companies over the last three years in terms of contributions received in the year, assets under plan by the end of year, and assets under management by the end of year are given in Table 2. (For purposes of this table, a zero value is assigned when no appropriate data exists for calculation of the year-to-year growth rate)

According to the observations in Table 1 and the Table 2 series, the pension companies had dramatic increases in the business of Employer Sponsored Plan in 2008, but then experienced a less significant growth of business in 2009 and 2010. The growth level is approaching a stable level quickly. However, it's reasonably expected that the pension companies shall achieve a more favorable market share expansion since the pension companies can provide the Employer Sponsored Plan a set of attractive annuity products through affiliate companies, which is an important advantage for pension companies as the market player to operate any DC plan.

A significant progress in the new regulation involves endorsement of Multiple Employer Sponsored Plans and amendment of the implementing rules with regard to Multiple Employer Sponsored Plans. Currently, there are 36 Multiple Employer Sponsored Plans created and provided by the 12 licensed financial institutions, including the five pension companies. Table 3 gives out the details.

Various efforts have been made by the policy makers the to prompt a continuous and healthy growth of Employer Sponsor Plans, but the outcome so far is not optimistic.

Table 2 series-B
Growth Rate for AUP

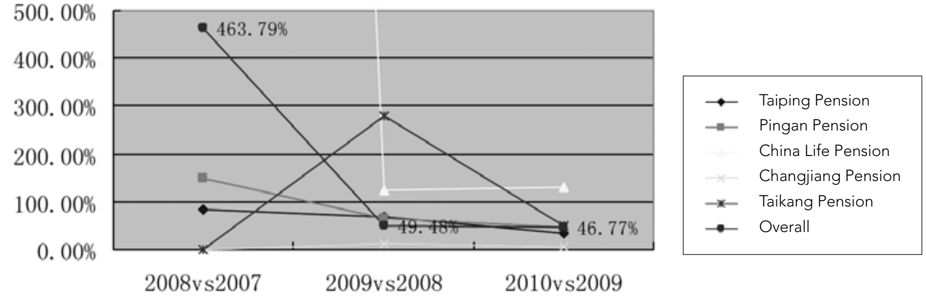


Table 2 series-C
Growth Rate for AUM

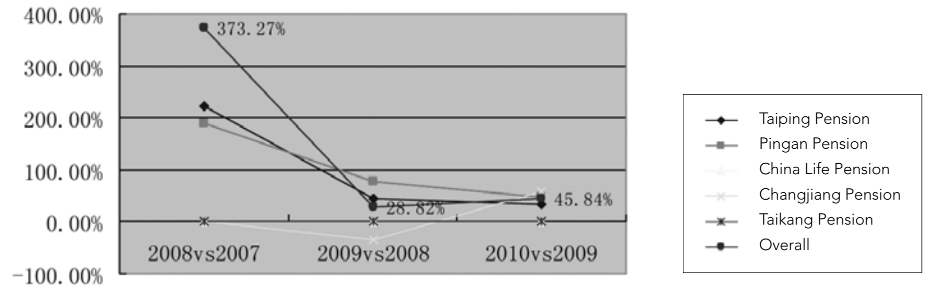
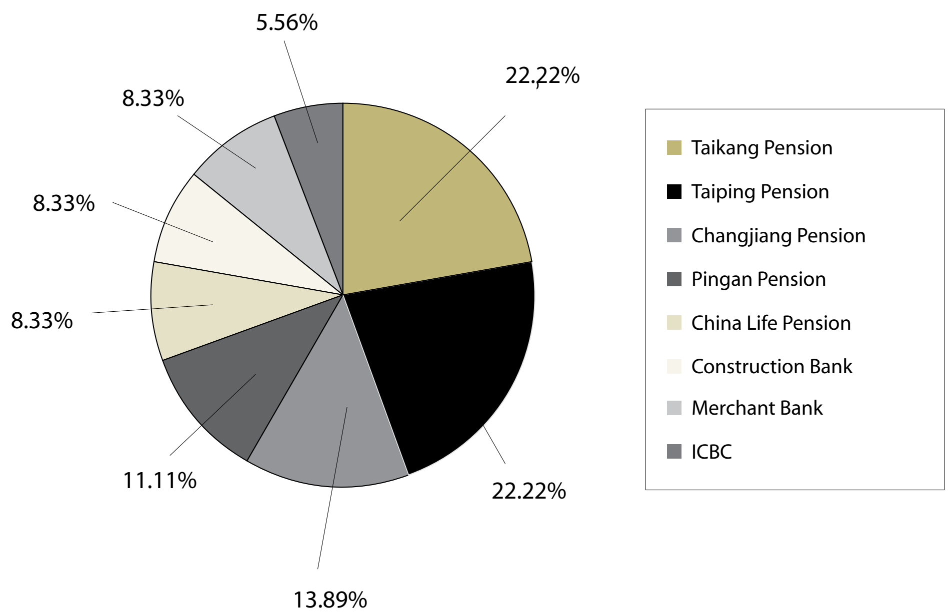


Table 3
Multiple Employer Sponsored Plan Product Distribution



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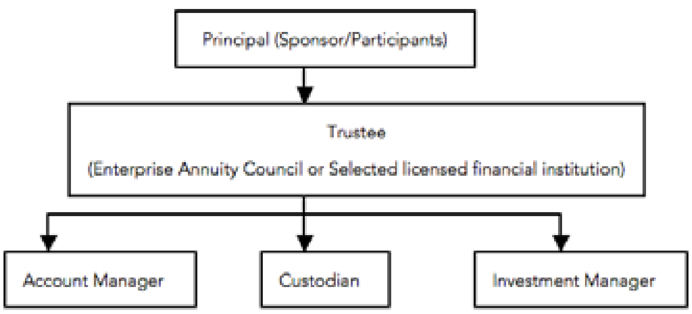
EXISTING ISSUES

We have identified various issues in the current Employer Sponsored Plan (ESP) regulatory regime which have significantly deterred market expansion of Employer Sponsored Plans in China.

Plan Structure and Ethics Issues

Currently, the ESP has been required to adopt the following governance structure.



The public has raised several significant questions on the governance structure:

1. The regulation allows a licensed trustee to serve as the investment manager if the trustee is also a licensed investment manager. The dual role of a licensed financial institution as both a trustee and an investment manager, or even the potential of such dual role in future arrangement is perceived to significantly aggregate information asymmetry, performance valuation, and self dealing issues in practice.

2. The regulation requires that investment managers can purchase financial products that it supplies only subject to consent of the trustee. When the trustee serves as the investment manager also, such regulatory requirement is superficial per se. The regulation can be easily circumvented by purchasing financial products from the affiliates of the investment manager or trustee.

3. The lack of a comprehensive code of conduct on the pricing and sale of financial products by affiliates may lead to higher costs, a higher expense component in financial products, as well as undesired and/or inefficient use of assets under management. Additionally, fair dealing requirements have not been addressed for plans within a single trustee, and have not been adequately addressed within a single investment manager.

Accessibility

The market for Employer Sponsored Plans in China suffers from low accessibility. The responsible regulator has so far granted only 12 licenses to financial institutions to provide trustee services, and in fact excludes most well qualified market players to enter and compete in the market. The choices available to the market are limited in both number of service providers and in the geographic coverage. The existing licensed trustees operate primarily in three major cities in China and they have inadequate extension to most regions in China, although they usually have some kind of national business network through their affiliates. The current market players have a strong preference to develop nationwide plans for state owned and nationally operated enterprises, or focus on the biggest customers, and disregard local needs.

The lack of Multiple Employer Sponsored Plans has also contributed to low accessibility which the new regulation purposes to cure and also improve portability. Despite the current official endorsement of Multiple Employer Sponsored Plans, portability of the account for an individual participant under a specific Multiple Employer Sponsored Plan is significantly restricted, and consequently the choices available to individual participants are limited.

Voluntary basis

An Employer Sponsored Plan is on a voluntary basis, which means the employer is not required to provide any employer sponsored plan as a supplementary source to its required contribu-

> We have perceived a very strong market potential for Employer Sponsored plans in the future ...

tion to the public pension plan for its employees. The employer also has full discretion to decide the amount of matching contributions to an Employer Sponsored Plan if it sponsors any such plan. Additionally, the lack of nondiscrimination rules allows the employer to arbitrarily select qualified employees or set disproportionate arrangements for different classes of employees. The voluntary basis has made Employer Sponsored Plans unattractive when cost is a concern of the employer. No initiative from employees or trade unions can be legally made to prompt establishment of an Employer Sponsored Plan, or even arouse the awareness of the value of such a plan to employees.

Tax Incentives

In absence of any tax incentives, the cost of Employer Sponsored Plans will be unaffordable for both employers and employees. As an example, currently the Shanghai Municipal Government requires that the employer must pay 22 percent of payroll to the public retirement plan and 12 percent of payroll to the public health and care plan. The employee must pay 8 percent of payroll to both the public retirement plan and the public health and care plan. The additional cost from an Employer Sponsored Plan will be a significant burden for both employers and employees. Consequently, only a handful of companies in a monopoly industry or other very prosperous industries can accommodate such additional costs. With serious concern about the disproportionate effect on different income classes, the national authority is reluctant to grant an explicit tax incentive to Employer Sponsored Plans, which usually results in more benefits to higher income earners. Nevertheless, some local governments have given out some types of tax incentives to qualified Employer Sponsored Plans, such as percent matching contribution from employers are tax deductible up to four percent of pay. The national authority has been considering the possibility to allow the Shanghai Municipal Government to grant tax deferred treatment to individual employees with regard to the matching contribution received.

Investment Restrictions

The regulation has set unreasonable restrictions on investments by an Employer Sponsored Plan:

1. The maximum allowed asset allocation to equity and equity related assets is 30 percent;
2. No foreign investment is allowed;
3. The types of permitted investment are strictly limited.

Such restrictions are perceived to unreasonably depress the yield for plan assets, reduce the diversification effect from a broad investment universe, and inappropriately address the needs of inflation protection as a common issue in an ordinary Employer Sponsored Plan.

Lack of Prudent Regulation

The licensed financial institutions in the market are subject to different regulatory systems in their primary business sector, and they receive additional regulation from the responsible regulator, the MHRSS. Conflict of regulatory authority and gaps between regulatory regimes have been identified to be in violation of the prudent regulation principle.

Policy Advices

After full consideration of the policy purpose, issues in the market, and relevant experience from advanced markets, we provide the following policy advice.

Uniform Regulation

Uniform risk capital based regulation can serve as the basis to reasonably incorporate existing diverse sources of regulatory requirements into

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a workable regulation regime without creating an unreasonable burden for licensed financial institutions of various types. Risk capital based regulation can also lead to a comprehensive ERM framework to cover operational risk, credit risk, and liquidity risk in addition to the market risk covered in the new regulation. A uniform regulation regime can also serve to facilitate ease of market participation in a controllable manner.

Workable Ethics Framework

Some workable framework readily available in the market on ethics and a code of conduct with regard to operation and supervision of Employer Sponsored Plans can be evaluated and selected as the basis to develop a set of implementing rules on operation. The selected basis may include the Assets Management Code and Pension Governing Body Code sponsored by the CFA Institute.

Various Incentives

Certain tax incentives, such as tax deferred treatment, will not create an immediate disproportionate result on the pyramid of income earners, but it will help to minimize the issue of significantly lower replacement ratios for higher salary earners in the future. Non tax incentive measures can also be explored. Opt-out opportunities for higher salary earners to conditionally leave the mandatory plan and instead participate in an industry plan may also serve a good function as the U.K. experience tells us.

Open Market

The improvement of market efficiency for Employer Sponsored Plans can be achieved through:

1. Allow more business players to enter the market, and particularly encourage those with experience in advanced markets and those having a strong incentive in serving the local interest.

2. Allow more permitted investment vehicles in a progressive manner, i.e., cross border investment, alternative investments.

3. Establish transparent and competitive pricing and sales practices with regard to using assets under plans to purchase or commit to purchase annuity products from the market, and allow more insurance companies to enter this market.

4. Educate participants through a well structured process, guidelines, and the introduction of intermediary services such as actuarial services in addition to legal and audit services already in the new regulation.

CONCLUSION

We have perceived a very strong market potential for Employer Sponsored Plans in the future despite the predominance of an overwhelming public pension system in China. Our society members also call for a reliable mechanism to facilitate appropriate financial arrangements to fit their specific retirement needs. The questions are whether our policy has gone or will go the direction as expected or intended? Whether our decision making system is readily and reliably responsive to the welfare of the general public? Whether we have a set of sound sources and resources to address the policy issues appropriately? The questions remain unanswered.

Notes:

The official term for an Employer Sponsored Plan in China is Enterprise Annuity Plan. The official term for a Single Employer Sponsored Plan in China is Sing Plan, while the term for a Multiple Employers Sponsored Plan is Collective Plan. We use the American counterpart term to accommodate the convention of the target audiences. In China, the officially recognized Employer Sponsored Plan is a DC plan. □