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Latest Developments in the China Pension Market

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Introduction

In November 2007, for the second time, China Ministry of Labor and Social Security (MOLSS) issued a series of licenses to qualified financial institutions that participate in the supplemental pension market. The first time was in August 2005, one year later after the government started the major supplemental pension reform by introducing Enterprise Annuity (EA)—the second pillar of old age security system.[1]

Brief History

The Chinese government started pension benefit reform in 1991. In the 90s, discussions and high level policies about supplement year for pension benefits started to emerge. 2004 was a milestone year for pension reform. The government issued two major regulations defining EA framework. More regulations followed providing guidance on implementing EA for companies.

Market Forces

The supplemental pension plans have been growing substantially in the past a few years. By the end of 2006, over 24,000 companies had set up supplemental pension plans for about 9.64 million workers. The assets under management are about RMB 91 billion. As of September 2007, there is RMB 34.4 billion of pension funds under EA structure.[2]

Employer sponsored supplemental pension plans existed as additional benefits to employees long before the reform in 2004 but in a different format. Some major corporations or industries established their own fund, managed by self-selected fund managers; some provincial social security agencies (e.g., Shanghai) also managed supplemental pension funds for companies while managing basic social security funds. Another popular choice was a group annuity product provided by insurance companies. The estimated combined fund size of all three types was about RMB 93 billion as of the end of 2004. Under the new government policy, all supplemental pension plans should be transferred to the EA structure.

Currently, the biggest demand for EA is from large state owned enterprises (SOEs). These companies are controlled by the central government or government agencies who occupy critical industries such as energy, telecommunication, infrastructure, finance, and manufacturing. These companies normally generate very high profit margins and provide good benefits to their employees. They also follow government policy very closely and in many cases are the beneficiaries of economic reforms. These companies are in the process of transferring their old plans to EA or establishing EA under the guidance of the government policy.

China EA Characteristics

The current proposed EA structure in China is similar to 401(K) plans in the United States, with some unique characteristics due to the current policy and market environment.

- The plans are voluntary.
- The plans are sponsored by employers. Employees make contributions to their personal account with matching contribution from their employers.
- They shall be defined contribution (DC) plans.
- The tax treatment of EA plans is not particularly favorable. On the employee side, there is no tax exemption or tax deferral for EA contributions. Realized gains in the EA accumulation phase are not taxable as long as they remain in the plan framework. The income from the withdrawal phase is exempted from income tax, the same as the social security pension benefit. On the employer side, the matching contribution to EA plans is partially tax-exempted. Normally the contribution is tax exempt up to a limit. The rules are determined by the provincial government.

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[1] The World Bank presented the idea of the "three pillars" of old age security in the 90s: basic social security benefits, employer sponsored supplement pension benefits and employees' personal savings.

[2] Released by MOLSS in November 2007 in a licensing announcement conference.

- Plan investment strategy is determined by fiduciaries following regulatory guidelines, and asset management companies make specific investment decisions. There are limitations for different investment vehicles. Each pension plan is managed as a whole with no difference among individual employees. As a result, most of the time, employees are not able to make their own investment decisions based on life cycle or risk preference.

Table 1: Limitation on Investment Vehicles

Investment vehicles	*Limitation*
Short-term bank deposit, treasury bills, short-term bonds, money market	No less than 20% of net asset
Bank CDs, negotiable deposit, government bonds, corporate bonds, fixed income mutual funds	No more than 50% of net asset with no less than 20% in government bonds
Stocks, stock mutual funds, savings insurance products	No more than 30% of net asset with no more than 20% in stocks
Assets invested in a single fund or entity	On the market value basis, no more than 5% of the total asset of the bond or fund; no more than 10% of net asset

Players in the EA Market

Financial institutions have been working to enter the market since the opportunities emerged. There are four major roles in the EA system: the fiduciary, the custodian, the asset manager and the administrator. Players in the EA market have to be licensed by MOLSS. Qualified financial institutions may apply for more than one license and will need approval from MOLSS. The licensing process is not as transparent. The qualification requirements are subject to government explanation. So far, banks are the biggest winners in the licensing competition.

Chart 1: Relationship Among Service Providers of EA Plans in China

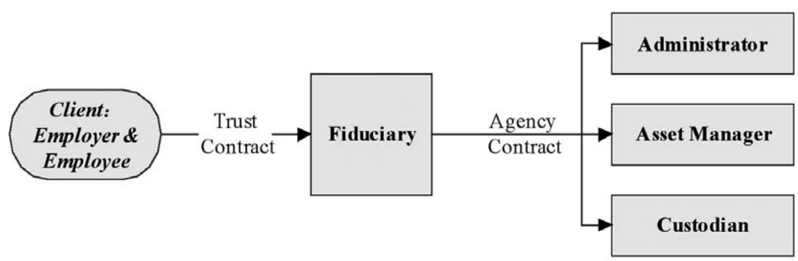

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Table 2: Licenses Distribution in Financial Sector

	Fiduciary	*Administrator*	*Asset manager*	*Custodian*
(November 2007) 24 licenses to 18 institutions	3 banks; 3 pension management companies, one of them was not invested by insurer; 1 trust company	3 banks; 4 pension management companies	3 fund management companies; 2 life insurance asset management companies; 1 pension management company	4 banks
(August 2005) 37 licenses to 29 institutions	3 banks; 3 fund management companies; 4 banks 2 pension management companies invested by life insurers; 4 life insurance companies; 9 fund management companies;	4 life insurance companies; 5 banks; 2 trustee companies	9 fund management companies; 2 pension management companies; 2 insurance asset management companies; 2 security companies	6 banks

Up to now, 61 licenses were given to 41 financial institutions. Five fund managers are joint ventures so far.

Looking Beyond

Since the EA system was initiated three years ago, significant progress has been made and yet there is still a long way to go before establishing a mature and effective supplemental pension system.

The market potential is huge. The World Bank estimated that the EA market will reach USD 1.85 trillion by 2030.[3] The Chinese government has also been actively involved in regulating pension reform introducing new policies and promoting EA system. A new corporate tax law took effect Jan. 1, 2008 in which more favorable tax treatments are applied to EA contributions.

International corporations and financial institutions have started to pay more attention to this market. As mentioned above, five licensed asset management companies are joint ventures. Lately, American International Assurance Company (AIA) showed interest in forming a pension service company with a Chinese partner. American Council of Life Insurance (ACLI) has also asked the Chinese government to simplify the licensing process in order to attract more participants from outside of China to this untapped market. ☐

[3] 2007 Q1 quarterly EA report from *www.cnpension.net.*