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Fast Forward, China: World's Fastest Growing Economy Focuses on its Private Pension Market

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We've heard the news, seen the gravity-defying statistics, and the ebullience persists—China's economy continues to roar. Multinational companies are entering the Chinese market at a rapid rate, pumping millions of dollars into the Chinese economy. The Chinese in major cities are becoming richer and, in general, are enjoying better living conditions than the preceding generation. China is firmly on its path of changing from a developing country to a developed one.

But hidden in the backdrop of China's rapid growth lurks an aging population, a result of China's one-child policy and the improved longevity of its people. The "4-2-1" phenomenon, characterized by a family structure of four grandparents, two parents, and a single child, is becoming more prevalent. While this aging society is not immediately apparent—in fact, many multinational companies employ a young workforce, with very few grey-haired employees—a demographic shift is inevitable.

Historical background

In the mid 1990s, China accepted the World Bank's three-pillar model for pensions, comprising a:

I. a pay-as-you-go, statutory pension plan operated by the Ministry of Labor and Social Security (MoLSS);

II. a mandatory defined contribution scheme, with contributions from both companies and employees, administered by provincial and municipal bureaus of the MoLSS; and

III. a scheme, consisting of voluntary corporate supplemental retirement plans.

Pillars I and II are administered and managed by the government, and it is widely acknowledged that these plans are massively underfunded in several provinces and cities. Although most multinational companies have made the required contributions to the programs, many domestic Chinese companies in poor financial health have not made the mandatory social insurance contributions. Even where Pillars I and II are properly managed, they provide inadequate pensions for higher wage earners due to relatively low (by multinational company standards) salary caps.

Voluntary corporate plans have historically been rare in China, largely owing to a lack of tax incentives, the unregulated pension environment and a lack of choice and sophistication with regard to funding vehicles. Consequently, many of the initial voluntary corporate arrangements were unfunded and set up as book reserve type arrangements. The tax implications of such arrangements are unclear and are determined on a case-by-case

(continued on page 24)

basis. Although book reserve arrangements remain an option today, many companies have since considered other vehicles to set up corporate plans.

A Framework: Enterprise Annuities

In April of 2004, the government issued legislation intended to provide a framework for voluntary corporate pension plans known as enterprise annuities (EA). This term derives from the literal translation of the Chinese phrase, but it is misleading because there is no requirement to provide such annuities. Some of the key features of the legislation include the following:

- The plans must be defined contribution schemes (by reference to individual accounts and maximum contributions).
- Companies setting up an EA plan must appoint a trustee, responsible for appointing qualified service providers—plan administrators, investment managers and custodians. And EA assets must be managed separately from the assets of the company and the service providers.
- Both companies and employees should contribute to the EA plan, with annual company contributions not exceeding 1/12 of gross payroll of the previous year, and combined company and employee contributions not exceeding 1/6 of gross payroll of the previous year. (The legislation has not provided any guidelines for minimum contribution requirements.)
- Up to 30 percent of the assets may be invested in equities, although overseas investment is not currently permitted. The remaining 70 percent must be invested in safer, but lower-yielding assets such as bonds and fixed deposits.
- Individual vested account balances must be portable from one company to another when employees change jobs.
- At the legal retirement age (currently age 60 for males and 55 for females), the individual account balance can be paid either as a lump sum or in installments. Individuals who emigrate overseas and beneficiaries of individuals who die before retirement age are permitted early withdrawal of funds.

The EA legislation has left many unanswered questions. For example, it is not clear what specific tax relief will be applied to employer contributions, but it was explicit that employee contributions would be post-tax. In China, taxation requirements are subject to the rulings of provincial governments that control tax legislation and collection in China. Until this critical question is answered, it is difficult to predict how successful the EA system will be.

Recent developments

The EA market is expected to be regulated tightly—particularly in the wake of recent fraud in the Chinese financial services sector. All EA service providers need to be licensed, and the government has, as of August 2005, granted 37 licenses to various institutions (five trustee licenses, six custodian licenses, 11 administration licenses, and 15 investment management licenses). All EA licenses are granted to Chinese companies who lack experience in the pension area. In due course, we anticipate that foreign firms will eventually enter the market, importing the know-how of more mature pensions markets. EA products are now available in the market and some companies have implemented EA plans. While this is a welcome development, we anticipate that EA plans and providers will experience some growing pains (if they haven't already).

Since the issuance of the EA legislation, close to a dozen provinces have issued their own legislation providing tax relief to company EA contributions, ranging from 4 percent to 8 percent of salary. We also continue to hear that the government is close to finalizing details of a nationwide tax treatment of EA plans, but remain cautious on this news. Seasoned observers remain skeptical that this can be accomplished in short-term, given the politics between the various ministries involved and the competing interests of central and provincial governments.

What Actions are Multinational Companies Taking?

Assuming that sufficient tax incentives are provided, most observers agree that EA plans will become the norm in the future. Because of the unresolved questions at this

time, many companies are adopting a "wait-and-see" approach to the EA market. However, we have noticed that Chinese companies have a head start in setting up EA plans.

But for some multinational companies, particularly those that have been established in China for many years and have a relatively long-serving staff, retirement benefits are becoming a popular way to retain employees in a job-hopping market. As mentioned above, some companies have already established voluntary retirement plans and others are moving ahead to implement supplementary plans using existing available vehicles. While about 20 percent of plans use a book reserve for both defined benefit and defined contribution plans, funded approaches are also possible.

The most common alternative to EA plans are pension insurance contracts offered by a handful of insurance companies, accounting for approximately 47 percent of supplementary pension plans, according to a Mercer survey. The tax deductibility of these insurance contracts is subject to the local tax bureaus' approval.

One other common concern among multinationals is to find appropriate pension coverage for their non-Chinese national employees (*e.g.*, expatriates and foreigners hired locally). Many employers, aware of China's underdeveloped pension market, are uncomfortable with offering local products to their foreign employees, especially those accustomed to the level of service and sophistication of mature pension markets. A growing trend is to cover such employees by an offshore plan, with Hong Kong being one of the popular locations for such a plan. Offshore products are available only to foreign employees in China and do not enjoy any tax deduction on the contributions.

Summary

Few other countries in modern history have elevated themselves from impoverished nations to economic powerhouses in such a short period of time. But it's worth noting, as measured by GDP per capita, that developed countries became rich before they became old. For China, the greatest concern is that it may become old before it becomes rich[1]. While China's future growth remains promising and continues to attract billions of dollars in investment, its private pension market cannot be ignored. Every day, multinational companies are making difficult business decisions in China. Those familiar with China know that decisions are made under very complicated situations and ambiguous regulations. Doing business in China requires patience. Multinationals face complex issues regarding Chinese pension plans. They need to develop a long-term strategy now, rather than later, for facing these issues so they can thrive in this increasingly competitive landscape. ◆

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1 "The Graying of the Middle Kingdom—The Demographics and Economics of Retirement Policy in China," R. Jackson & N. Howe, CSIS (Center for Strategic and International Studies) and Prudential Foundation, April 2004.