Retirement and Savings Plans in China

David Moo, Hewitt Associates

July 2009
Key theme: Corporate-sponsored retirement and savings plans in Mainland China

Title: Retirement and Savings Plans in China

Author: David Moo, FSA
Senior International Benefits Consultant, Hewitt Associates (Shanghai)
David.Moo@Hewitt.com
+86 21 2306 6884

Abstract
Retirees in China have historically relied on their family and their government to sustain them in their old age. Both of these pillars are crumbling to varying extent, and workers are increasingly going to need to rely on other sources of retirement income. Employers are beginning to step in to fill this gap. However, companies are providing retirement or other savings plans in many different ways. This paper will provide a summary of the methods being used (based on different plan designs and investment structures in particular), the efficacy of each, and what changes are needed to improve the situation for companies, their employees, and the society in general.
Introduction

China has undergone many dramatic changes in the last 100 years. The government leadership has changed from an Emperor to the Nationalists to the Communists, with foreign and civil wars interspersed. Since the Communist takeover in 1949 and the beginning of “New China” there have been great upheavals and reorganizations of society, from the Great Leap Forward and the Cultural Revolution to Reform and Opening. With all of this dynamism, it can be difficult to take a long-term view of some of the challenges China is currently facing, including in respect of the aging population.

China, like many countries, is aging rapidly due to a combination of decreasing birth rates (exacerbated in China by the one-child policy) and a longer lifespan. In fact, according to the Population Reference Bureau, China’s population is aging at one of the fastest rates ever recorded. The United Nations projects that the ratio of workers to retirees will decrease from 9 to 2.5 by 2050. There will be a heavy burden on upcoming generations to support the elderly during retirement – and thus it is vital to begin saving for this future soon.

As in most countries, there are several ways the saving can be done; the World Bank defines this in terms of the “3 pillars” of retirement income security: government-provided social security, employer-provided supplemental savings programs, and individual savings. This paper will examine each of these pillars, with a focus on the methods used by employers to address this critical issue.
Social Security Pension Provision in China

History
China's first old age pension system was established in 1951 under the State Council’s Regulations on Labor Insurance. Since then, China's pension system has gone through several stages of reform precipitated by changes in the political, economic, and social environment. The original system was funded by modest employer contributions to local and national pools and provided on a pay-as-you-go basis. During the Cultural Revolution (1966-1976), social insurance became the responsibility of enterprises: each enterprise paid the pensions of its own retirees out of its current revenue. The unified pension pooling system was eliminated, and accumulated pension funds in the national pool were used for other purposes. Supervisory responsibilities were transferred to local labor bureaus.

Soon after China announced its open-door policy in 1978, the government began to redevelop the social security system, including reintroducing pooling in 1986. However, as a result of government policies like the one-child policy and expensive early retirement incentives designed to provide employment opportunities for young workers, as well as the transition from a planned economy to a market economy, the pension system entered the 1990s and the first decade of the new millennium in crisis. State-owned enterprises (SOEs) have heavy pension obligations at a time when employment in these enterprises is decreasing and the number of pensioners relative to employees is increasing. Many of these SOEs have only recently begun taking responsibility for their profits and losses, and many cannot manage their pension burden. Moreover, the government realized that it cannot afford to bear pension obligations by itself.

In 1991 the government instituted additional reforms, including calling for individual contributions by all employees and for experiments with individual accounts. It recognized the need for the traditional three-pillar system.

Throughout the late 1990’s, experiments with individual accounts within the social security system, and with various levels of pooling, were undertaken. Many valuable lessons were learned, but there was also much confusion over who had authority over the system and how to unify the disparate programs. Thus, in March 1998, the Ministry of Labour and Social Security (since renamed the Ministry of Human Resources and Social Security, or MOHRSS) was created in order to consolidate the various departments that had been responsible for some aspects of social security and pension policy. However, even with the centralization of authority in the MOHRSS, many departments within MOLSS, as well as the Ministry of Finance and the National Tax Bureau, continue to influence the evolution of the basic pension system.

The Current Social Security Pension System
The current social insurance pension plan in China was established by State Council Document No. 26, issued on July 1, 1997 and updated by Document No. 38 in 2005. The plan is broadly consistent with World Bank recommendations; its goal is to transition the defined benefit, pay-as-you-go system to a three-pillar model, while incorporating all enterprise and self-employed workers in cities and townships.
Pillar I is composed of two parts:

- Social Pooling (Pillar IA): Enterprises, in general, contribute a tax-deductible 20% of their total wage bill (specific contribution rates are determined by the provinces and municipalities; in all cases the wages used to calculate the contributions are subject to a maximum of 300% and minimum of 60% of average wages in the locality); and

- Individual Account (Pillar IB): Employees contribute (before tax) to individual accounts. In general the contribution rate is 8% of wages (again subject to the 300% of average wages maximum) to the individual account. These accounts were designed to be fully funded; in reality many provinces have been using these funds to support Pillar 1A and other, non-pension obligations and the individual accounts are purely notional.

These accounts are also credited with interest each year (at a rate announced by the local government). Recent rates have been in the neighbourhood of 4%.

Eligibility requirements under the current system are age 60 for males (age 55 for certain hazardous industries), age 55 for female cadres, and age 50 for female workers. An employee must have 15 years of contributions.

The social security pension retirement benefit consists of the following tax-free amounts:

- **Benefits from the social pool**: The monthly pension is a percentage of the city average salary (CAS), based on the average of the CAS and the employee’s indexed contribution salary, multiplied by an accrual rate of 1% for each contribution year. The formula is:

  \[ 1\% \times \left( \text{years of contributions up to 30} \right) \times \frac{\left( \text{CAS at retirement} + \text{Index} \times \text{CAS at retirement} \right)}{2} \]

  \[ \text{Index} = \text{Average of the following ratio over all years of contribution:} \]

  \[ \frac{\text{Individual's salary up to 3 x CAS}}{\text{CAS in that year}} \]

  This benefit is payable for life, and is defined as a constant percentage of CAS (and thus increases with CAS over time).

- **Benefits from the individual account**: The individual account balance is converted to a monthly life annuity pension using a life annuity factor determined by the government (see table below). This benefit remains level (it is not indexed for inflation or salaries).

- For individuals retiring with service years prior to the time the social security pension system was established (in the early 1990s), a **transitional benefit** is provided from the social pool.

In most cases the “city average salary” does not necessarily represent actual average salaries paid. These figures are calculated by the local governments based on data provided to them by companies in their area – data which is often understated (likely as a tax avoidance measure). As an illustration, in Shanghai the CAS used for Social Security and other purposes is RMB 3,292 (per month), effective 1 April 2009. So, an employee earning over \(3 \times 3,292 \times 12 = \text{RMB 118,512}\) would be allocated the maximum contribution to the social security pension fund. According to Hewitt Associates’ 2008
Total Compensation Measurement survey, only employees in the manual workforce are earning below the CAS, and almost all employees at the Senior Professional or Supervisor levels (below middle management) are earning above the 3 x CAS limit. It is conceivable that a well-educated employee could spend nearly their entire career receiving pay at a level above that limit.

**Example Benefit Calculation**

Once the employee reaches retirement age, (s)he is likely to have reached at least a Senior Management level. At current levels, such employees have an average pay level (in Shanghai) at approximately RMB 550,000. For such an employee, if retiring with the maximum 30 years of service, all of which was paid at or near the 3 x CAS limit, the total pension benefit would include:

- **Benefits from the social pool**: based on the formula shown above, this employee’s Index would equal 3, so the benefit would equal:

  \[1\% \times 30 \text{ years} \times \frac{(\text{CAS} + 3 \times \text{CAS})}{2} = 60\% \times \text{CAS}\]

  At current levels, that is about RMB 1,975 per month: about 4.3% of the average pay at this job level.

- **Benefits from the individual account**: assuming the individual was participating in the system for the entire career (in reality this would not be possible today), the total account balance would be 8% of 3 x CAS each year, increased with interest. To again oversimplify, assume that credited interest matches CAS increases over the course of the career (in reality, CAS has been increasing at rates above 10%, compared to the approximately 4% interest credited). Then this new retiree receives a monthly benefit of:

  \[8\% \times 3 \times \text{CAS} \times 30 \text{ years} / \text{Annuity Factor} = \frac{720\% \times \text{CAS}}{(139/12)} \text{ (age 60 annuity factor)}\]

  \[= 62.2\% \times \text{CAS}\]

  This is about RMB 2,047 / month, or about 4.5% of the average pay at this job level.

- Since the assumption is that this person participated in the individual account system for the entire career, there is no transition benefit payable.

So, under the (generous) simplifying assumptions, this individual would receive a social security pension benefit of less than 9% of pay. This would match the amount received by anyone with this amount of service and earnings above 3 x CAS for the career; for someone paid exactly that amount at retirement, the total replacement would be about 40% of final pay. The percentages decline for anyone at higher pay levels.
### Table of Social Security Individual Account Annuity Factors

<table>
<thead>
<tr>
<th>Retirement Age</th>
<th>Annuity Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>40</td>
<td>233</td>
</tr>
<tr>
<td>41</td>
<td>230</td>
</tr>
<tr>
<td>42</td>
<td>226</td>
</tr>
<tr>
<td>43</td>
<td>223</td>
</tr>
<tr>
<td>44</td>
<td>220</td>
</tr>
<tr>
<td>45</td>
<td>216</td>
</tr>
<tr>
<td>46</td>
<td>212</td>
</tr>
<tr>
<td>47</td>
<td>208</td>
</tr>
<tr>
<td>48</td>
<td>204</td>
</tr>
<tr>
<td>49</td>
<td>199</td>
</tr>
<tr>
<td>50</td>
<td>195</td>
</tr>
<tr>
<td>51</td>
<td>190</td>
</tr>
<tr>
<td>52</td>
<td>185</td>
</tr>
<tr>
<td>53</td>
<td>180</td>
</tr>
<tr>
<td>54</td>
<td>175</td>
</tr>
<tr>
<td>55</td>
<td>170</td>
</tr>
<tr>
<td>56</td>
<td>164</td>
</tr>
<tr>
<td>57</td>
<td>158</td>
</tr>
<tr>
<td>58</td>
<td>152</td>
</tr>
<tr>
<td>59</td>
<td>145</td>
</tr>
<tr>
<td>60</td>
<td>139</td>
</tr>
<tr>
<td>61</td>
<td>132</td>
</tr>
<tr>
<td>62</td>
<td>125</td>
</tr>
<tr>
<td>63</td>
<td>117</td>
</tr>
<tr>
<td>64</td>
<td>109</td>
</tr>
<tr>
<td>65</td>
<td>101</td>
</tr>
<tr>
<td>66</td>
<td>93</td>
</tr>
<tr>
<td>67</td>
<td>84</td>
</tr>
<tr>
<td>68</td>
<td>75</td>
</tr>
<tr>
<td>69</td>
<td>65</td>
</tr>
<tr>
<td>70</td>
<td>56</td>
</tr>
</tbody>
</table>

**Employee Expectations and Low Social Pension Benefits**

As a legacy of the old “iron rice bowl” mentality, Chinese employees expect that their government and employers should be responsible for some, if not most, of their retirement income. However, the current mandatory pension system in China provides insufficient retirement income, especially for employees with income levels above 300% of the city average salary. Thus the Chinese workers will need to have other sources of income in retirement. Before focusing on Pillar 2 (employer-provided programs), it may be helpful to consider the third pillar – individual (and family) savings.
Individual and Family Savings

China is known to have a high national savings rate – recently reaching over 50%. The national savings rate includes corporate and government savings, but a major factor in the country’s very high national savings rate is a very high personal savings rate. In 2007, the household savings as a share of the household disposable income was about 30% - compared to rates below 10% in much of the West, and the 15-20% rates typical in Japan, another Asian economy with a culture of saving.

There are a number of factors that contribute to the high savings rate, including:

- Cultural tendency toward savings
- Lack of social safety net for medical, education, and retirement costs
- Quickly increasing incomes resulting in less dependence on current income for regular consumption
- Shang Jin Wei and Xiaobo Zhang show that families are saving as a means of competing for scarce brides for their sons (the one-child policy combined with a penchant for boys has resulted in a large gender imbalance – and not enough brides for all the young men). (The Competitive Saving Motive: Evidence from Rising Sex Ratios and Savings Rates in China; Shang-Jin Wei and Xiaobo Zhang; NBER Working Paper No. 15093; June 2009)

Further analysis of the reasons for the savings is outside the scope of this paper. However, in analyzing the need for employer-sponsored pension programs, this savings rate has several implications. The main questions to consider are:

- How much of the savings will be available at retirement? Are these high savings rates sustainable?
- How much of the savings would an employee be interested in diverting to an employer-provided program?

The first question is difficult to answer from the available data. It is not clear that the 30% savings rate is perpetual – it is significantly higher than savings rates in the 1980s and 1990s. The rate could continue to grow in the near term, but in the medium to long term it can likely be expected to decline to international, or at least regional, norms.

Part of the decrease will likely be driven by spending of portions of the savings already built up – as demonstrated above, many of the drivers for the high savings rates are items that will result in pre-retirement consumption (medical, education, and wedding expenses or transfers to the next generation).

Interestingly, much of the transfers to the next generation can be considered a form of retirement savings. As in many Asian countries, there is a strong cultural tendency for
supporting one’s parents in retirement. Many homes consist of a family with the grandparents taking care of the child while the parents both work. Thus, the money given by parents to their children may be used to purchase a home they will themselves live in during retirement.

This traditional arrangement has begun to decline in recent years, as Chinese families become more mobile and individuals begin to desire more independence from family responsibilities. The one-child policy also results in many retired workers without a child to support them (for instance, it is more common for the father’s parents to live with them than for the mother’s parents, so parents of only a daughter may not have the option available). It will be many generations before a significant decrease takes place in this cultural feature, but the gradual decline has begun already.

Savings rate are also likely to decrease as the unsustainable wage increases of recent years begin to ratchet down. At this point, consumption spending will begin to “catch up” with earnings and reduce the amount saved.

Even if savings rates decline to a regional standard of, say, 15-20%, the resulting nest egg, when combined with social security, could be sufficient for a reasonable retirement, especially if a decent real rate of return is earned on the savings. However, despite gaining interest in equity investing as the Chinese stock market develops, most household savings are currently being held in banks, which generally will not provide a rate of return significantly higher than inflation.

As Mr. Takatoshi Kato of the International Monetary Fund reiterated recently, a vital part of China’s efforts to increase domestic consumption (by reducing savings rates) will be “increasing the range of savings vehicles for households to provide alternatives to bank-intermediated financing.” Employers may be one stakeholder to provide such an alternative, through company-sponsored savings programs. In the same speech, the IMF representative expounded on the need for expanded use of private pensions. How are employers responding to this demand?

Employer-sponsored Savings Programs

Clearly, the inadequate social security system creates a need for additional savings programs. For cultural and social reasons, workers in China are likely to appreciate the opportunity to build up additional savings – if they can be convinced the employer is providing a better vehicle than they can find on their own.

What criteria may be important to workers in China? Some possibilities include:

• Tax effectiveness. Investment earnings are already largely tax-free for individuals, so the key here is to provide deferral (or reduction) of current income or payroll taxes as an incentive. Unfortunately, as discussed below, such tax effectiveness is difficult or impossible to provide under current regulations.

• Low Risk. Personal savings in China are currently being largely held at banks – a safe option. Employees may not be willing to divert money to an employer-provided vehicle if it is not considered safe – there is a fairly low tolerance for risk.

• Returns. Of course, if there is a low tolerance for risk then there must also be somewhat low expectations for returns. It would not be difficult to develop a low-risk strategy that can still provide better returns than bank deposits. Additionally, there are certainly many employees who would enjoy the opportunity to participate in the booming (and occasionally busting) equity markets.

• Security. Related to the low risk tolerance, and to China’s (and the rest of the world’s) recent history of financial (and other) scandals in supposedly well-regulated industries, employees need greater assurance about the soundness of the institutions holding their savings.

• Flexibility. Chinese workers build up lifetime assets in a variety of ways, including through housing purchases (often with significant down payments) and intergenerational transfers (as discussed above). Such methods of accumulating wealth require employees to be able to access their savings – without significant penalties – throughout their career, instead of waiting until retirement.

It will be valuable to keep these criteria in mind as we consider the options employers have available for providing wealth accumulation programs to their employees. First, it will be helpful to understand what employers are already doing. This discussion will focus on multinational companies operating in China – the market practice for local state-owned or private enterprises is vastly different for historical and cultural reasons.

Market Practice

Despite an imperfect legal framework, supplemental pension plans are developing quickly in China in a variety of forms. In addition, many employers are providing other wealth accumulation programs not specifically focused on retirement. These programs
provide the opportunity for employees to access their wealth accumulation benefits during their career for purposes such as housing, medical, or educational expenses.

**Wealth Accumulation Benefits Prevalence**

![2008 Benefits Plan Prevalence - 1st Tier City and Leading Company](image)

Source: Hewitt 2008 TCM Survey. 1st tier city: 386 enterprises operated in Shanghai, Beijing, Guangzhou, and Shenzhen; Leading: 127 companies which are *Fortune 500/Global 500* listed companies in China

In 2008, about 40% of all multinational companies operating in first tier cities in China provided wealth accumulation plans to employees, including pure pension plans (17%), supplemental housing funds (22%), and general purpose savings plans (4%). These prevalence rates are not as high as typically seen in fully developed markets such as Australia, Japan, Hong Kong, Europe, and the US, due largely to the younger workforce at multinational companies in China and the lack of government mandates or proper incentives.

**Plan Design**

The following market prevalence data comes from the Hewitt 2008 TCM Survey of 386 enterprises located in first tier cities (Shanghai, Beijing, Guangzhou, and Shenzhen).

**Eligibility**: Most pension plans (81%) and the majority of savings and housing programs (over 65%) are available to employees at all levels (often after meeting some service threshold; for instance after a 3 to 6 month probation period). Other employers provide their plans only to employees in certain key positions.

**Employee Contributions**: Employee contributions are quickly increasing in prevalence – currently over 50% of pension plans allow or require employee contributions. Fewer non-pension savings programs provide for employee contributions. Prevalence is not higher than this due to a lack of tax incentives and perceptions of a lack of sophistication among employees. However there is a distinct trend among multinational companies to at least provide a facility for employees to contribute to their wealth accumulation, and often to encourage the participation by either requiring the contributions or by matching the employee contributions with employer contributions.

**Employer Contributions**: Most employers (about 60%) provide a fixed rate of pay contribution to the wealth accumulation program; a sizable minority of non-pension-focused plans provide a fixed rate with an offset for mandatory housing fund contributions. Pension contributions are rarely offset, since the employees do not directly benefit from employer pension contributions (which go into a social pool rather than an individual account). Typical contribution rates are around 7-10% for a flat rate program.
Other structures used include service-based, job level based, or matching contribution schemes.

**Vesting:** Vesting schedules vary by the type of plan. Pension programs typically employ a graded vesting schedule (46%) often reaching 100% only after 8 or 9 years. Immediate vesting is the next most prevalent schedule (28%); this is largely due to the past popularity of making supplementary pension contributions to the social security bureau, which required immediate vesting. As this option is no longer available, fewer companies will employ immediate vesting schedules in the future.

Most housing programs historically provided immediate vesting; however this is again due to the use of the government’s provident housing fund as administrator of the system. Another vesting schedule popular for savings and housing programs is a rolling schedule in which each year’s contribution vests, for example, 3 years after it is made.

**Distributions:** Again, this feature varies by the type of plan. Pension plans typically focus on retirement, but most (82%) also pay out vested account balances at termination prior to retirement. General purpose savings programs and housing programs additionally provide for in-service distributions; housing programs theoretically would restrict distributions to housing costs, but in fact 60% of reported housing programs do not have restrictions on in-service distributions of vested account balances. Such programs are identified as housing funds for employee appreciation purposes, even though the funds are available for other purposes as well.

**Operation Model:** As of 2008, less than one third of supplementary pension programs set up by multinationals in China are utilizing the Enterprise Annuity (EA) system. Many other pension programs historically used the local social security bureau to hold their contributions; but these will soon be entirely gone as the government has disallowed future contributions to this system. Other popular models for pension programs include insurance companies (67% of non-EA plans) or no external funding (18%). A newer model which does not yet appear in the data is the trust model (the Enterprise Annuity system is also a trust model, but this refers to non-EA trusts).

General purpose savings plans and housing plans are more likely to fund internally (or not at all). Housing funds historically often made supplementary contributions to the local provident housing center, but again this practice is decreasing and the other models are becoming more common. See the next section for more details on the available models.

**Sample Programs:** The above detail may not provide the clarity for the reader to picture a typical wealth accumulation program in China. Thus the following samples (none of them based on specific cases) will be helpful in understanding the data more clearly:

- **Enterprise Annuity plan:** a typical EA plan will provide a flat 5-7% of base pay, possibly with additional matching contributions for voluntary employee contributions, with a 3-5 year vesting schedule. Employees may be able to allocate their investments among a small number of options. Other pension programs will look similar, but may have longer vesting schedules and higher contribution rates (due to lack of regulatory limit), especially if unfunded (since investment returns will not increase the value of the employer contributions over time).

- **Savings program:** Employer promises 10% of pay each year, with a 3-year rolling vesting schedule. The contributions are automatically paid to the employee from
general assets after the 3-year period (possibly with nominal interest). Some savings programs do provide features that more closely approximate a long-term savings plan, but many are essentially just deferred compensation programs. These programs may utilize a non-EA trust system or an internal book reserve; some insurers are able to offer workable products for this as well despite some regulatory restrictions on in-service withdrawals.

Non-EA Operation Models
Much attention has been focused on the Enterprise Annuity model in China, as the official government-sanctioned program for providing supplementary pension plans to employees. However this is by no means the only viable option.

Voluntary Contributions to the Local Social Security Bureau
Each city and province in China has its own mandatory pension fund and the contribution level and benefit payout are different for each locality. In 1997, the Shanghai Labor and Social Security Bureau (SLSSB) pioneered a supplementary plan, which other provinces replicated. Under the plan, participating employers contribute a certain amount for each employee to the Bureau and the contribution is allocated to the employee’s individual account. The tax authority treats this contribution as a business expense, and therefore, it is tax deductible for the employer. The benefit is tax exempt to the employee upon receipt.

Specifically, enterprises in Shanghai would pay 22% (the same rate as the social pension insurance contribution) of their total cash compensation to the pension center; for any pay exceeding 300% of City Average Salary (CAS) the associated contribution is deposited into a supplemental pension account set up for each such enterprise. Since special tax incentives are offered on both individual income tax and corporate tax for the top-up contribution, many foreign invested enterprises (FIEs) began such programs. Over RMB 10 billion (USD 1.5bn) in supplemental pension assets accumulated over the years.

On August 25, 2006, the Chinese state media reported that the Beijing central government sent more than 100 investigators to probe a corruption case at the SLSSB, reportedly the biggest instance of corruption in Shanghai in decades. The case allegedly involved the mishandling of RMB 3.2 billion (USD 400 million) of the social pension fund by Shanghai officials and businessmen for real estate and other business ventures.

In September 2006, the Ministry of Labor and Social Security (MOLSS) issued Document 34 in response to the alleged misuse of supplemental pension funds by the SLSSB. Under the provisions of Document 34, all local labor and social security bureaus, including SLSSB, are no longer allowed to accept voluntary top-up contributions from employers as supplemental pension plans. Existing supplemental pension funds that are managed by local labor and social security bureaus should be transferred to a qualified EA service provider by the end of 2007. In practice not all funds were transferred by that date but there are no more contributions being made to the local social security bureaus.

Insured Pension Products
All major national domestic insurers (China Life, China Pacific, PingAn Life, Taiping Life, Tai Kang Life and New China Life etc), as well as some foreign-invested insurers that have obtained group insurance licenses (Generali and AIA in particular), have been marketing group pension products. Most of these products have a defined contribution (DC) approach, including such features as investment choice for employees (with a
guaranteed return available with the standard products), vesting schedules, and matching contribution schemes.

Because of historical abuses of such programs as a tax shelter, there are some regulatory constraints on group insurance products. For instance, it can be a challenge for a group pension product to allow for in-service withdrawals (thus making housing or general purpose savings programs more difficult).

In addition the tax treatment is not favourable. As with all non-EA models, there are no specific corporate tax breaks available (although many companies have been able to deduct the premiums as part of their general “welfare fund” expenditures). The regulations are clear that employees must pay income tax on the contributions when they are made. Since these tax payments will generally reduce the contribution to the insurance company (as opposed to reducing the employee’s take-home pay), the impact is most largely felt by the employer through reduced forfeitures (as any tax payments made for contributions subsequently forfeited due to early termination are unlikely to be recovered from the government). Investment income and distributions are not taxable to the employee.

The major arguments in favour of insured pension products in China are the security and services provided by insurance companies. The insurance industry is well-regulated and there are a large number of competitors on the market working to improve their offerings. Insurance companies also provide a “one-stop-shop” solution for companies wishing to outsource the operation of the program to one partner.

Trust Products
In many countries the most common tool used for supplemental pension contributions is the trust, providing asset independency, security for the employees, and a recognized regulatory framework. In China these products are at an earlier stage of development, for several reasons. First and foremost, the trust law in China is not written with supplemental employee benefit plans in mind (EA plans use a trust model but rely on separate, EA-specific regulations for the trust aspects). In fact, there are some provisions regarding the “trustor” and “trustee” that make it difficult to design a workable product. Another issue is that the perceived security of trust companies in China is relatively low due to historical, widely-publicized scandals involving the industry. In general, trust companies do not attract the same level of regulatory and public support that insurance companies enjoy.

However several trust companies operate in China and provide trust products to employers for purposes of employee savings/pension programs. One company pioneered a new product in 2007 which allows multiple companies to enroll their employees in a pooled product offering the full suite of features expected of defined contribution plans in China today. Larger companies can set up individual trusts with a variety of trust companies, allowing for more control over investment portfolios and other aspects of plan operation.

Trust companies have the greatest potential to compete against insurance companies in the area of investments. Insurance companies all over the world are expected to invest conservatively – they will likely provide their greatest value in bond and other low-risk portfolios. Trust companies can offer investment products that can be expected to perform well across a broader range of asset classes. Of course, this is a highly generalized statement based on the experience of other countries – there is not enough
historical data in China to compare the investment performance of insurance companies as opposed to trust companies.

In addition, trust products can provide a higher degree of flexibility. There are fewer limitations on plan design (in-service withdrawals are not an issue, for example). And because the tax laws do not take these products into direct consideration, there is room for flexibility in interpretation. Many companies have consulted with their local tax authorities and received favorable results, including a corporate tax deduction for company contributions (utilizing the general welfare fund), and individual income tax deferred to either vesting or distribution.

**Internal Unfunded Account**
Some multinational companies have chosen to provide supplementary benefits through a book reserve. Under this method, the employer allocates contributions to a special or notional account and there are no external assets. Of course, this approach provides maximum flexibility, but suffers from potentially volatile accounting liabilities, some significant cash flow issues, and a lack of either investment returns or benefit security for employees. Tax treatment is also unfavorable: employers are not permitted to take a tax deduction for any notional contributions to book reserves; benefits become a deductible expense only upon payment. For large payments, the high marginal tax rates that apply can greatly reduce the value to the employees.
Enterprise Annuity

Overview
Enterprise Annuity (EA) is the government advocated and authorized supplemental pension plan; in other words, the only “qualified” employer retirement plan in China. As with most national qualified retirement systems, the EA program provides enterprises with some tax incentives, with a corresponding trade-off in the degree of flexibility regarding plan design and operating structure.

Basic Requirements
Employers implementing an EA program are required to participate in the mandatory basic pension system (social security) and be up-to-date with their contribution responsibilities. They must also be financially able to make the additional contributions.

Plan provisions and plan changes must be approved by employees through a collective agreement mechanism, which may be a labor union or committee of employee representatives. The plan document should be filed with the Department of Labor Security in the province where the enterprise is registered (or at a level higher than district or county). Large state-owned enterprises (SOEs) must file the plan document with the Ministry of Human Resources and Social Security (MOHRSS) and be approved by the State-owned Asset Supervision and Administration Commission of the State Council (SASAC) as well.

Previously multi-national companies with entities in multiple locations throughout China filed their plans with the MOHRSS. However, in spring 2008, the MOHRSS announced that they will no longer accept filings from foreign-invested enterprises; these plans must be filed at the provincial level. In general, a company should still be able to file and operate one plan (instead of separate plans in each location); the filing should be recognized by other provinces (with coordination from MOHRSS as needed). In determining where to file, the organization should consider, first, the location of the headquarters of the holding company; otherwise the location with the largest number of employees or the longest history in China may be appropriate.

Plan Design
The plan provisions must be put in writing in a formal plan document. The document must address eligibility, funding, administration, fund management, accounting, benefit payment options, plan management and supervisory process, and any circumstances under which contributions may be suspended.

Eligibility
Employers can freely select plan eligibility requirements based on age, years of service, performance targets, job level, salary, or other specified criteria. Although regulations do not specify a plan coverage ratio the authorities are most likely to approve plans with at least 70% coverage. As noted above, only Chinese citizens are eligible. In practice, 87% of EA plans included in Hewitt Associates market survey provided the plan to all employees; 90% made it available to them no later than at the end of their probation.
**Plan Type and Contributions**

The EA is a fully funded defined contribution plan with individual accounts. The maximum annual employer contribution is limited to one-twelfth of the previous year’s total payroll (note that not all of this is necessarily tax-deductible). The maximum total contribution (employer and employee) must not exceed the total of two months’ average pay from the previous year. While both employers and employees are required to contribute, there is no minimum contribution level specified; in practice employers who do not wish to require employee contributions will set the minimum employee contribution level at 1 yuan (about 14 cents in the US).

The majority of employers (58%) provide a flat rate of base pay contribution (generally from 5% to 8%). About one-quarter of the EA plans surveyed vary the employer contribution by employee’s age, length of service, job category, or other criteria (e.g., performance targets). Only 6% of employers provide matching contributions for employee voluntary contributions (although the rate is higher among multinationals); and only 3% of plans are integrated with the Social Security system. If the government continues to promulgate stringent non-discrimination requirements (see Taxation and other Regional Variations section below), flat rate contribution schedules will predominate (often with a cap as well).

**Vesting**

Employee contributions are fully vested immediately. Currently, EA guidelines do not regulate the maximum years for the vesting of employer contributions. However, in practice the government authorities have been less willing to approve plans with vesting schedules more than eight years or so; some officials have even required vesting schedules to be as short as 3 to 5 years (see Taxation and other Regional Variations section below).

The most common vesting schedule currently is a graded vesting schedule, commonly reaching full vesting by the fifth year. About a third of the plans in our survey provided for immediate vesting, and another significant minority provide a cliff vesting schedule (again, generally at 3 to 5 years).

Forfeitures (unvested employer contributions remaining when an employer terminates) may be reallocated to remaining participants or used to offset future employer contributions.

**Benefit Payments**

The account balance is payable at the statutory retirement age (currently, age 60 for males and age 55 for female nonmanual workers and age 50 for female manual workers), on death, or on establishing permanent residence outside of China. On retirement, the account balance is payable as a lump sum or in instalments. On death and permanent emigration, the account balance is payable as a lump sum.

On termination prior to retirement, employees can transfer their account to their new employer’s EA plan. If the new employer does not have an EA plan (or if the employee terminated their employment to continue their education, join the army, or withdraw from the labor force), the employee must leave their account with their former employer’s EA plan administrator where it will continue to earn investment returns (but no further capital).
**Investments**

Fund assets must be invested according to EA regulations and may be in bank deposits or managed by qualified investment managers. In today’s market, qualified investment managers include licensed mutual fund companies, pension insurance companies, and securities companies that are authorized to manage separate accounts.

Asset allocation is restricted by EA guidelines. No more than 50% of net assets may be invested in fixed income securities; no more than 30% of net assets may be invested in the equity market; and no less than 20% of net assets may be invested in the money market. All assets can be invested only domestically in China.

In general employers have limited influence over the investments of the plan assets. The investment manager will determine the actual securities to purchase; the employer’s role is limited to development of the overall investment strategy (including defining the risk tolerance and resulting asset allocation) and ongoing monitoring of the chosen investment manager(s). Many providers can provide the facility for employers to pass the risk tolerance choice on to employees. The employees may be able to choose between a conservative, aggressive, and balanced fund (for example). Forty-five percent of potential EA implementers would like to utilize this feature, but in practice only 25% of the current plans in Hewitt’s survey do so.

The risk inherent in plan investments is a top concern employers have when implementing EA (or other invested) plans in China. There are several reasons for this concern, including:

- A particularly volatile market (Shanghai stock exchange return for first half of 2007: 41%; for first half of 2008: -48%)

- A (perceived) lack of employee understanding of the vagaries of investing – and therefore the potential for significant employee dissatisfaction with the employer during market downturns.

- The lack of any EA investment options with guaranteed principle

- A general lack of long-term focus due to the turbulent political and economic modern history of China.

Reuters publishes a composite China Pension Index to measure benchmark EA returns. Over the first 3 years of the index (from 2006-03-31), the annualized returns of the most aggressive portfolio were over 12%; the least aggressive portfolio (50% fixed income / 50% money market) returned about 3.6%. Of course this masks the volatility: over the 2008 calendar year, the more aggressive portfolio lost nearly 10% while the less risky option returned over 9%.

**Taxation and other Regional Variations**

Tax incentives are set by the regional governments and vary from 4% to 12.5% (see chart below). For example, employers in Beijing can deduct up to 4% of total payroll for contributions to their EA programs. With regard to individual income tax (IIT), employee contributions are made on a post-tax basis; IIT regulations do not address whether employer contributions to an employee account are considered taxable income.
In addition to the variations in tax policy and filing processes, some of the provinces have begun enforcing other policies not included in the national regulations. Most recently (and perhaps most significantly), plans being filed in Shanghai must now comply with stricter design standards, including:

- **Nondiscrimination**: the largest employer contribution to a single employee can be no larger than 3 times the average employer contribution to all employees. It is not clear that there are any exceptions for situations where participation is voluntary or employee contributions are matched. There is an exception application process built in, involving tri-partite representation from the Shanghai General Union, the Shanghai Enterprise Confederation and the Shanghai Social Security Bureau.

- **Vesting**: the Shanghai Social Security Bureau is unlikely to approve plans with vesting schedules longer than 3 to 5 years. In addition, the plan must provide for automatic vesting for employees who voluntarily terminate employment at the completion of a signed service period – thus the vesting schedule needs to be coordinated with the length of employment contracts.

- **Forfeitures**: forfeitures should make up no more than 10% of the total employer contribution in any year.

- **Vendors**: the Custodian should be separate from the Trustee for the plan. For companies using external trustees, this results in a need for at least three separate vendors (trustee, custodian, and investment manager); the account administrator role could be filled by one of the three if desired.

Similarly, Shenzhen has announced a nondiscrimination policy similar to Shanghai’s, except that the limit is set at 5 times the average contribution rate (instead of 3 times). And Guangzhou has begun asking EA plans to withhold Individual Income Tax (IIT) from employer contributions at the time the contribution is made. All of these issues reduce the flexibility and desirability of the EA model and will encourage some employers to utilize other, more flexible options.
<table>
<thead>
<tr>
<th>Region</th>
<th>Tax Incentive</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anhui</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Beijing</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Chongqing</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Fujian</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Guangdong</td>
<td>4%</td>
<td>IIT collected at contribution</td>
</tr>
<tr>
<td>Guizhou</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Hebei</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Heilongjiang</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Hubei</td>
<td>12.5%</td>
<td></td>
</tr>
<tr>
<td>Hunan</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Jiangsu</td>
<td>12.5%</td>
<td></td>
</tr>
<tr>
<td>Jilin</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Liaoning</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Qinghai</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Shandong</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Shanghai</td>
<td>5%</td>
<td>Additional Plan Design Restrictions</td>
</tr>
<tr>
<td>Shanxi (3)</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Shanxi(1)</td>
<td>8.3%</td>
<td></td>
</tr>
<tr>
<td>Shenzhen</td>
<td>5%</td>
<td>Additional Plan Design Restrictions</td>
</tr>
<tr>
<td>Sichuan</td>
<td>3%–5%</td>
<td></td>
</tr>
<tr>
<td>Tianjin</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Xinjiang</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Yunnan</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Zhejiang</td>
<td>5%</td>
<td></td>
</tr>
</tbody>
</table>

**Plan Management and Operation**

The trustee can be an EA committee consisting of employer and employee representatives or a licensed, qualified external organization. If the trustee is an internal EA committee, employee representatives must make up at least one-third of the committee members. The committee may invite external experts to provide professional advice. The trustee is responsible for selection of the investment manager(s), account administrator, and fund custodian (unless the investment fund already has one). All four service providers must be licensed by MOHRSS.

The decision to create an internal EA Committee or to outsource trusteeship to an external professional organization is critical and is generally based on an enterprise’s management philosophy and the availability of internal resources. In practice, SOEs have been more likely to create an internal EA committee than FIEs.

For those companies who choose an external trustee, best practices would still suggest a need for an internal Pension Committee to oversee the trustee and other vendors, review investment returns, ensure the plan remains compliant and competitive, and drive appropriate employee communications. This last responsibility is vital to the success of an EA program or any benefit program – the company will see a return on the investment in employee engagement only if the employees understand and appreciate the program. Thus it is vital that the sponsor of the program not entirely abrogate the responsibility for effective communications to outside vendors.
**Trustee**
The government has recognized 11 trustee providers. The trustee is empowered to select, supervise and change the Account Administrator, Custodian, and Investment Manager. The trustee is also responsible for collecting employer and employee contributions, making payments to EA plan beneficiaries, developing the EA investment strategy, and preparing financial/accounting statements and fund performance reports on a regular basis. If the trustee is also qualified to provide account administration or investment management, the independence of each function must be ensured.

**Account Administrator**
Sixteen banks or trust companies have been qualified as Account Administrators. The Account Administrator records employer and employee contributions and EA investment returns, calculates EA benefits, and cross-checks the EA account balance with the Custodian. The Account Administrator prepares regular reports for the trustee and other relevant supervisors.

**Custodian**
Ten banks are qualified custodians in the EA system. The Custodian must have the ability to safeguard EA Fund assets, with a safe and effective transaction and clearing/settlement system. The Custodian establishes the capital and security accounts in the name of the EA Fund. The Custodian distributes the EA Fund assets to Investment Managers according to the trustee’s instructions and conducts timely clearing/settlements and transactions according to the Investment Manager’s investment instructions.

**Investment Manager**
A qualified Investment Manager must be an independent legal entity registered in China and approved by financial regulatory institutions. The legal entity must be qualified for trust investment management, fund management, or asset management. Twenty-one securities, insurance, and fund management companies have been qualified as EA Investment Managers. In addition to investing EA assets, the Investment Manager checks the accounting and valuation results with the Custodian. An Investment Risk Reserve Fund must set up to offset future losses (if any) caused by an Investment Manager’s misconduct. The Investment Manager must prepare regular reports for the trustee and other relevant supervisors.

**Market Data**
By the end of 2007, about 32,000 companies with 10 million employees (and RMB 151.9 billion, or US$22 billion) had joined the EA system (MOHRSS has not released updated figures for 2008). The large majority of these companies are State-Owned Enterprises; multinational companies have taken up EA in much smaller numbers thus far. As shown previously, about 17% of multinational companies in China currently offer a supplemental pension program. Of these, less than a third are Enterprise Annuity programs. Many companies are still waiting for further clarification on some of the regulatory issues, and to see where the market goes.
The Future

Faced with increasing challenges in providing adequate retirement income for workers in China, both the government and employers will continue to adapt and innovate in the coming years. The World Bank has recommended, as a first step, that the government increase the normal retirement age to a uniform age 65 (Paper No. 2005-1 by Yvonne Sin). The government has resisted the change on the grounds that it may increase unemployment; however it seems likely that this change will be gradually implemented in the future.

There is also a significant push from the World Bank and other NGO's, from the employer community, and from within parts of the government itself, towards greater unification of policies across the country. This can be expected, in the long term, to include national social security systems and, in the nearer term, a national tax policy for EA schemes. The very existence of a national, uniform policy would be a great encouragement to many companies; if the details of the policy are also reasonable then it can be expected that many more companies will implement EA plans. The most important incentive for most companies is related to the tax treatment: if reduced, deferred, or waived taxes (for employees and employers) can be provided through a savings program, many more companies will be willing to divert funds from cash compensation for this purpose.

It can be expected that China’s three pillar retirement system will continue to evolve, always remaining distinctly Chinese but also taking on the best features from other systems in the world. Government policies will change, the vendors in the market will continue to improve, capital markets will become more transparent, and employees will become more cognizant of the need for retirement savings. Eventually supplemental pension plans will be as common in China as in other countries with inadequate social provision. Companies that enter the market sooner will be a step ahead of their competition for talent, and their employees will have more time to build sufficient retirement savings. But employers must be flexible and prepared to adapt to the ongoing regulatory and market changes – changes that are occurring as fast as the changes in the skylines in China’s many modernizing cities.