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Role of Insurance Companies in Pension Business  
China Experience

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# Overview

- Pension Funds in China
- State Pension System
- Supplementary Corporate Pension
- Insured Pension Plans
- Enterprise Annuities
- Insurance Companies in EA
- Conclusions

# Pension Funds in China

- Old system provides replacement ratio of 80%
- China has introduced three-pillar pension system
  - Slightly different definition than the world bank
- Pillar I – state administered social security system
- Pillar II – Enterprise Annuity
  - Voluntary privately managed pension plans
  - Government supervised and tax-exempt
- Pillar III – voluntary private pension plans
  - No tax exemption
  - Less government supervision

# State Pension System

- Administered by local taxation bureau and MOF
- Contributions based on covered wages
  - Minimum 60% and maximum 300% of local average wages
  - Employers – 20% of covered wages
  - Employees – 8% of covered wages
- Retirement Age
  - Male 60 / female 55
- Retirement Benefits – DB and DC
  - DB - basic pension of 20% of average local wages
  - DC – Individual Account based on 11% contributions
    - Aim to give 38.5% replacement ratio
  - Combined replacement ration of 58.5%

# State Pension System– Current Issues

- DC component
  - Notional account as part of the pay as you go system
  - Contributions used to pay current benefits both DC and DB
  - May not support current annuity conversion factor of 10
    - Improving longevity of the population
- DB component
  - Pay as you go system
  - Taken over past pension liabilities of old system
  - Funded by 17% employer contributions
  - MOF subsidies, lottery proceeds
  - Proceeds from sales of government owned shares in SOE
  - Diversify investment portfolio and professional management

# Supplementary Corporate Pension

- Forms of supplementary pension plans
  - Employer self-administered plans
  - Industry self-administered plans
  - Social Security Bureau administered plans
  - Local government administered plans
  - “Insured” plans of insurance companies
    - Dominant pension service provider

# Supplementary Corporate Pension – Insured Plans

- Design of pension plans
  - Mostly DC plans
  - Flexibility in plan rule design
    - Contributions based on service, age, salary, rank, etc.
    - No standard vesting rules
  - These plans are not regulated
    - No regulations on the change of plan rules
    - Flexibility in paying plan contributions
      - Rare to find monthly contributions
  - Insurers are not empowered to monitor plan rules
    - Cannot enforce contributions in arrears
  - Insurer role is to administer deposits
    - Pay retirement and vested benefits

# Supplementary Corporate Pension – Insured Plans

- Taxation issues
  - Deductibility of employer contributions
    - If plan is tax-qualified by tax bureau
  - Employer contributions are not deductible
  - Interest credited to A/C by insurer is tax exempt
  - Benefits paid to employees are tax free
  - Concern about “money laundering”
    - High marginal tax rate on personal income of 45%
    - Giving employee tax free benefits who are about to leave
    - CIRC and tax bureau are strengthening enforcement
      - Immediate vesting not allowed



# Insured Pension Plans

- Most pension products are participating products
  - Guarantee rate is capped at 2.5%
    - Policy dividend can enhance return
    - Minimum 70% of interest gain be given back
  - Policy dividends are paid to the contributors
    - employee contribution dividends are paid to employee account as usual
    - employer contribution dividends are paid back to employer rather than credited to the employee account
      - Employers very interested in the dividend level
      - Competition on dividend level is very intense
      - Often face competitive bidding process on large clients
      - Quotations may not be set by the actuarial department

# Insured Pension Plans - DB

- Handling of DB plans (rather infrequent)
  - For pension benefits of retirees
    - Actuarial valuation of the liabilities of pensioners
    - Quotation on immediate annuities to cover pension benefits
  - For pension benefits of active members
    - Conduct actuarial costing exercise
    - Use deposit administration policy to accumulate funding
  - The employer may be a listed company
    - Provide actuarial service to value the pension liability and the annual cost of pension plan

# Insured Pension Plans – Investment

- General fund restrictions apply to non-investment linked products
  - No limits on government bonds, financial bonds and bank deposits
  - Max. 20% in AA rated corporate bonds
  - Max. 15% in mutual funds
  - Max. 5% in equities and CBs
  - 80% of foreign currency holdings can be invested in overseas bonds
  - May engage in repo/reverse-repo but not repo on repo
- Investment linked products are less restrictive
  - Not subject to limits on corporate bonds and mutual funds

# Insured Pension Plans – Investment

- Investment regulations are being relaxed gradually
  - The approach of CIRC is prudent and moving in the right direction
  - The question is more the shortage of good investments rather than the lack of investment channels as some have suggested
    - for products providing a hard investment guarantee, 20% equity exposure (5% direct + 15% indirect) is more than sufficient
  - Apart from reforming the equity markets, more attention should be paid to reform the China bond market
  - We have launched the 401K style plan in China
    - Clients still favor the guarantee fund when they are offered investment choice

# Enterprise Annuity (EA)

- The concept was introduced in 2000
  - Pilot program started in Liaoning in 2001
  - It is China version of 401K plan
    - Employer contributions up to 4% are tax-exempt
    - Employee contributions are not yet tax-exempt
  - Mostly plans administered by MOLSS can get tax exemption
  - China wants to extent the pilot program
    - More EA regulations are promulgated in 2004 and 2005
    - Make clear the intent to have privatize EA

# EA – Provisional Regulations

- EA is confined to DC plans
  - Max. contributions up to 2 months pay
  - Max. employer contributions of 1 month pay
  - Still need tax bureau to change the 4% limit on deductibility
- Preservation of benefits until retirement or death
- Portability of benefits upon change of employment
- EA plans are to be trust-based with four kinds of providers
  - Segregation of plan assets from those of the employer
  - Trustee is the central party to oversee the EA plan
  - Scheme Administrator responsible for day-to-day record keeping
  - Investment Manager responsible for investment management
  - Custodian responsible for asset custody
- Probably influenced by the MPF regulations of Hong Kong
  - Proximity of Hong Kong and MPF regulations are available in Chinese

# EA – Provisional Regulations

- Fees for EA plans and services are regulated
  - Trustee fee – max. 0.2% of assets
  - Scheme administration – max. RMB 5 per month per employee
  - Investment management – max. 1.2% of assets
  - Custodian fee – max. 0.2% of assets
- Service providers may apply for multiple licenses
  - Only banks can act as custodian
  - 2 specialty pension companies have been approved by CIRC
  - Expect service providers to co-operate to provide bundled services

# EA – Strict Investment Regulations

- Min. 20% in liquid investments
  - Including demand deposits, T-bills, short term reverse-repo, money market funds
- Max. 50% in term deposits, bonds (government, financial, corporate), CB and bond funds
  - Min. 20% in government bonds
- Max. of 30% in equities, insurance funds and equity funds in aggregate
  - Max. of 20% in equities
- Investment manager to retain 20% of management fees in investment risk reserve under trust to cover investment losses
  - Up to 10% of assets



# Enterprise Annuity Market

- Investment restrictions
  - These restriction could limit the offer of members' choice
  - Unclear if members' choice is allowed
- Fee regulation
  - Cap on scheme admin fees makes it difficult to operate unless with volume and subsidy from other services
  - Need scheme administration to take lead in EA market
- Market open up to all financial institutions
  - Similar to Hong Kong where insurers, fund managers, banks, trust companies all compete for MPF business

# EA – Insurance Companies Position

- Insurance companies are the dominant players in the pension market
  - Experience in scheme administration of pension plans
  - Having been offering insurance products to pension plans
  - Providing actuarial services to pension plans
  - Can offer annuity products to cover pension obligations
  - Can provide total solution to Employee Benefit programs
    - Group life, group health and accident coverage

# EA – Insurance Companies, Challenges

- EA is expected to phase out or replace the existing non-qualified pension plans over time
  - Very high corporate tax rate of 33%
- Insurers will face stiff competition from much bigger competitors in terms of size
  - Banks have a much larger corporate client base
  - Insurers may be less plagued by legacy financial problems
    - NPL of banks, insolvency of security firms
  - May need to form alliance with other financial institutions
- Insurers need to gather skills in equity investments
  - Insurers have strength in bond investments

# EA – Competitive Landscape

- Operating margin in China may be thin, e.g. high bank deposit interest rate, low foreign currency spread, low transaction fees
- Competition – ALL want to be the LEADER in terms of SIZE
- Competition on fees, e.g. front-end load on mutual funds
- Corporate governance not clear
  - Maximize return to stakeholders (may not be the shareholders)
  - ROE often not used as the benchmark
- The accounting of costs need to be improved
  - Highly decentralized operating units
- Did not fully price in the costs of operating business
  - Costs of doing business often understated

# Conclusions

- China's pension market has huge potentials
- But competition is expected to be keen
- Insurers need to maintain its existing advantages and to build up other expertise in pension business
- The EA system is expected to be improved over time
- Pension business is for the long term
- It takes time to build it up if you are not there now

Thank you