PENSION DEVELOPMENTS IN THE PRC

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Abstract. Mainland China's rapidly ageing population is attributable to two main factors, the 'one-child policy' plus substantial improvements in life expectancy, leading to a rapidly deteriorating dependency ratio. Whereas in 1970 there were 8 workers to every 1 retiree, that ratio is currently 6.4 to 1, and will further deteriorate to 2 to 1 by 2040. In addition to the ageing crisis is the shift in the fundamental structure of the Mainland economy. Until the late 1980s, the state, via its state-owned enterprises (SOEs), was responsible for providing generous pension to all urban retirees. This was a completely unfunded pay-as-you-go system based on current workers paying for previous generations. However this system became unsustainable as the economy continues to shift from one dominated by SOEs to one where the private sector is generating an increasingly larger share. Under these circumstances, the government took steps to reform its pension system into a three pillar system broadly in line with World Bank recommendations where the government, employers and employees all share the burden of providing for an individual's retirement security.

1 Introduction

As the most populated nation in the world that is growing old before it grows rich, mainland China has a bigger burden than any other country to put a sustainable old age security system in place. In 1970, the ratio of working age adults to those aged 60 and over was 8 to 1; currently, it is 6.4 to 1; by 2040, that ratio will deteriorate to 2 to 1. This demographic phenomenon is the result of two main factors: the 'one-child policy' and the substantial improvements in life expectancy. As a result, the so-called 1-2-4 phenomenon — one child, two parents, and four grandparents — is becoming apparent. In other words, each adult who will enter the workforce will be taking care of two parents and four grandparents.

Until the late 1980s, the state, via its state-owned enterprises (SOEs), was responsible for providing generous pension benefits of about 80% of final salary in addition to housing and other subsidies. However, this was a completely unfunded pay-as-you-go system based on current resources paying for previous generations, a system that was unsustainable as the fundamental structure of the economy continues to shift from one dominated by SOEs to one where the private sector is generating an increasingly larger share.

Under these circumstances, the government took steps to reform its pension system into a three pillar system broadly in line with World Bank recommendations where the government, employers and employees all share the burden of providing for an individual's retirement security. The current framework of this system was issued in July 1997 by the State Council in Document 26, *Establishment of a Unified Basic Old Age Pension Insurance System for Enterprise Staff and Workers.*

This article examines China's pension system as defined by Document 26 and the developments that have taken place in recent years.

2 China's Three Pillar Pension System

China's pension system as defined by Document 26 aims to incorporate all enterprise workers and self-employed in the cities and townships. This system as detailed in the table below is funded by employers and employees on a mandatory and voluntary basis. Benefits comprise of a subsistence level defined benefit paid from Pillar Ia, an earnings related defined contributions pension paid from Pillar Ib, and a possible voluntary supplementary pension paid from Pillar II or Pillar III.

Document 26 – System Design:

	Pillar Ia	**Pillar Ib**	**Pillar II**	**Pillar III**
Type	• Mandatory • Defined benefit • Pool at city or provincial level • Pay-as-you-go (eventually partially funded)	• Mandatory • Defined contribution • Individual account • Fully funded	• Voluntary/ Supplementary • Defined contribution • Funded	• Voluntary/ Supplementary • Unregulated/ usually no tax benefits • Generally insurance based plans
Who contributes what	Employer contributes about 17% of actual wages, on max and min. wages set at 300% and 60% of City Average Pay	• Employer contributes 3% of wages • Employee contributes 8% of wages.	Employers and employees are encouraged to contribute with tax benefits to be determined by provincial governments, expected to be up to 4% for employer contributions.	Employers contributes discretionary amounts
Benefits	At retirement age of 60 for men 55 for women, with at least 15 years of service, retirees receive a pension equal to 20% of City Average Pay indexed to a rate between consumer price inflation and salary inflation	Amount accumulated in the individual account at retirement divided by 120	Lump sum or annuity at retirement	Lump sum or annuity at retirement

The biggest challenge for provinces in implementing Document 26 was making financial provisions for the existing pension debt. Provinces with a heavy concentration of SOEs that were undergoing market reform could not meet the benefit payments under social pooling. Also, permitting early retirement of SOE workers hid the unemployment problem but added an extra burden to pension obligations. In addition, demographic differences between the provinces made the burden of the system very uneven.

Under Document 26, Pillar Ia is a pay-as-you-go scheme and contributions to this Pillar are used to pay current pensioners. Pillar Ib on the other hand is intended to be fully funded. However, in provinces where there is a higher concentration of SOE retirees, benefit payments exceed employers' contributions to Pillar Ia, and some or all of the money which should go into Pillar Ib individual accounts has been diverted to pay current benefits. It is likely that three-quarters of China's 31 provinces have not been able to properly fund the Pillar Ib individual accounts. However, where the funds are being diverted to meet current pension benefits, local governments are making book entries of all contributions and interest is being added on to these book entries. In other words, most individual accounts are currently notional. Yet, at retirement the individual account pensions have to be paid with real money. According to the Ministry of Labour and Social Security, approximately Rmb740bn is owed to individual accounts.

3 Northeast China Experiments

To address some of the challenges of implementing Document 26, in December 2000, the State Council issued Document 42, *The Pilot Program for Improving Urban Social Security System*. The major objectives of Document 42 were to adjust and perfect the unified pension insurance system stemming from Document 26.

Liaoning pilot

In July 2001, the government implemented Document 42 in Liaoning, a province with 42mn people in northeast China, which is home to one tenth of the country's large- and mid-sized SOEs.

The pilot programme also included amendments to contribution and benefit rates such that:

- pension benefits under Pillar Ia will increase to 30% of provincial average wages after 30 years of employment;
- all employer contributions go to Pillar Ia; and
- Pillar Ib will be funded entirely by employees with 8% contributions and will contain real assets, not notional accounts.

During the three year pilot period, the central government transferred subsidies of several billion Renminbi each year to make up funding shortages.

Jilin and Heilongjiang pilots

With lessons learned from Liaoning, the two other northeastern provinces, Jilin and Heilongjiang, started piloting their versions of Document 42 in May 2004. The Jilin pilot is guided by State Council Document 35 and the Heilongjiang pilot is guided by Document 36, although the contents of the two documents are identical.

It seems that these Documents were purposely written as vague, directional guidelines in order to leave room for detailed measures to be adopted during the implementation stage which extends to the end of 2005. Even so, these Documents do address two of the outstanding issues that are important factors in building a rational, sustainable pension system but were unaddressed by Document 42.

First, a change in the calculation of the basic social pool pension under Documents 35 and 36 discourages early retirement and gives an incentive for late retirement, therefore staving off the decline in the system dependency ratio. And second, the new calculation method for the individual account benefit takes into consideration actuarial reality. Instead of calculating these benefits based on the 120 factor as is the current Document 26 practice regardless of the age at which an individual retires, Documents 35 and 36 provide a schedule of age - specific actuarial factors for benefits calculation.

Documents 35 and 36 also highlight the need for individual account assets to seek diversified channels for investment in order to increase the investment returns of the accounts but do not suggest methods as to how this should be achieved.

Despite the lack of detail at this preliminary stage, the general direction of these amendments is an encouraging sign that the system is reforming in a way that makes economic sense.

Unified national amendments

Following the successful implementation of the three pilot programmes, starting from the second half of 2005, many of the amendments piloted there will be adopted nationally.

Whereas under Document 26, employer contributions of about 20% of wages were allocated between Pillar Ia and Pillar Ib, going forward the entire 20% will go towards meeting current pension benefits under Pillar Ia. After 15 years of service, retirees will receive a pension equal to 15% of the average of the local wage and their individual pre- retirement wage. For each additional year of service, retirees will receive one additional percentage point as pension, thus rewarding those who work for longer periods.

Pillar Ib individual accounts will be funded solely by the 8% employee contributions and all provinces will be required to fully fund this Pillar. Those provinces burdened with large numbers of pensioners can move towards full funding gradually by initially funding Pillar Ib with less than 8% contributions. The shortfalls will be made up by subsidies from local and central government.

Investment of Pilliar Ib assets

Now that a system has been put in place for assets to accumulate in individual accounts, guidelines for managing these moneys have become an issue that must be resolved before the central government starts allocating subsidies. Currently, the accumulated assets are required to be invested in deposits and government bonds. But returns from such investments do not keep pace with wage inflation, thus failing to meet a major objective of a funded scheme.

Changes to investment guidelines for accumulated reserves have been discussed amongst government ministries but so far no decisions have been made. Should these assets be managed by the NSSF or by provincial governments? And if they are to be out sourced to the private sector, should the central government via the MOLSS be responsible for selecting the managers or should the selection process be left to each provincial government? These are questions that the Ministry of Finance and the MOLSS would like to see resolved before subsidies are allocated.

The Liaoning government with Rmb13bn accumulated assets in Pillar Ib is reportedly exploring the possibility of outsourcing the investment management function to private sector asset managers. Undisclosed sources have suggested that the MOLSS has in principle agreed to entrust the NSSF with the accumulated assets in Jilin and Heilongjiang. But local governments in Jilin and Heilongjiang may wish to have other plans.

4 National Social Security Fund

In September 2000, the National Social Security Fund (NSSF) was established under the auspices of the State Council. In the event that some provinces have insufficient funds to meet Pillar Ia and Ib benefits, the NSSF is expected to serve as a 'fund of last resort'. Money comes into the NSSF from the central government and from the sell-off of state-owned shares equal to 10% of all moneys raised through IPOs and rights issues. However, this latter policy was suspended for domestic issues (but not for international fund raising), because of weakness in the stock markets. The IPOs of PICC Property and Casualty Company and China Life Insurance Company are two examples where the companies raised US$800mn and US$3.48bn, respectively, and 10% of the money raised was directed to the NSSF in 2003.

To strengthen its interest in state owned assets in the future, the NSSF submitted a proposal to the State Council for the establishment of a committee on the divestiture of SOE assets. This proposal was approved by the State Council in September 2004 and the committee was established with participation by the NCSSF, SASAC, MOF and CSRC[1].

As at the end of 2004, the NSSF had Rmb171bn (US$20bn) in assets invested across four asset classes: 39% in bank deposits, 43% in government bonds, 7% in strategic holdings, and 11% in stocks. In early 2003, the NSSF has out-sourced Rmb32.6bn to selected 6 local fund managers. The portfolios, which are invested in equities, bonds and T-bond repo contracts, are expected to achieve returns of 3% p.a. or more over the consumer price index, and at least 20% higher than the one-year Rmb deposit rate.

In October 2004, the NCSSF appointed four additional investment managers and is preparing to award additional mandates. In the near future it is hoped that the NSSF will be able to allocate a small proportion of its assets to international investments. The NSSF has already obtained approval for overseas investments from the State Council in February 2004 and is currently in the planning stage for international asset manager selection and international asset allocation. The NSSF

[1] NCSSF: National Council for Social Security Fund.
SASAC: State-Owned Assets Supervisory and Administration Commission.
MOF: Ministry of Finance.
CSRC: China Securities Regulatory Commission.

actually holds certain funds in foreign currencies. For example, the moneys raised in Hong Kong and New York listings were retained as approved deposits.

5 Enterprise annuity system

Under Document 42, the government stated that it wishes to encourage employers to establish an 'enterprise annuity' (EA) scheme for their employees. Enterprise annuity is the term used by the Ministry of Labour and Social Security (MOLSS) for a qualified supplementary pension plan.

According to the Document, an EA will be a defined contribution arrangement with funded, individual accounts. Both employers and employees can contribute to the plan, but employees are not required to do so. Contributions by the employer are expected to be tax deductible up to 4% of payroll. The account balance will be paid at the statutory retirement age, at which point the balance is payable as a lump sum or an annuity.

Pursuant to Document 42 the Ministry of Labour and Social Security issued Regulation 20, *Trial Measures for Enterprise Annuities,* and Regulation 23, *Trial Measures for the Management of Enterprise Annuity Fund.* These documents, which came into effect from 1 May 2004, set out the regulatory environment under which EAs should be established. Accordingly, EA plans must be set up as a trust and managed by approved investment managers, which in today's market may include licensed investment management companies, trust companies, asset management subsidiaries of insurance companies and securities companies that are authorised to manage separate accounts.

The MOLSS as well as influential industry bodies are keen on promoting this voluntary pillar, which further shifts responsibility for retirement provision towards individuals and employers; the more successful this voluntary Pillar II, the better the overall protection for retirement security in the light of the uncertainties of Pillar Ia and Pillar Ib.

As of May 2005, a total of 126 trustees, investment managers, administrators and custodians have submitted applications to the MOLSS for approval to operate as service providers for enterprise annuity schemes. The MOLSS is expected to announce the first set of approved providers in July 2005.

6 Conclusion

There are still issues outstanding in the pension systems that need to be resolved, but generally, reforms are moving in the right direction. Most importantly, the fundamental structure of the three pillar system that China has adopted diversifies the financial burden as well as the risk of default due to mismanagement or budget shortfalls. The system amendments piloted in the northeastern provinces, many of which are now being implemented nationally, and government policy that encourages the development of a private pension pillar are all steps towards ultimately creating a system that provides a redistributive subsistence income to all retirees, a fully funded individual account pension, and a possible supplementary account that rewards high savers.

Foreign institutions' entry into the China market post - WTO is increasing competition and raising standards of operation towards international levels in the financial services industry. Local companies are therefore rapidly reinventing themselves in order to compete effectively. These are very positive developments for pension fund management.

But there are still many uncertainties and pending issues to be resolved. To begin with, China's stock market is still immature with poor disclosure of information, a large over-hang of state owned shares, which could cause further declines, strong policy influences and scarcity of products, all of which reduces the investment attraction for pension assets. Human resources for the pension industry, including actuaries, fund managers, administrators and advisers is another area that will take time to develop.

China currently has a demographic window of opportunity to address these issues. That is, the number of workers entering the work force exceeds the number of retirees and will continue to do so, but only until 2015. China is therefore in a race to build a solid foundation for its pension system before the window of opportunity shuts down. Otherwise, the economy will be swamped by a tsunami of elderly people.

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