China's Corporate Pensions
- Current State and Future Challenges -

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I. Overview of corporate pensions in China

China's social welfare system has undergone gradual reforms since the 1990s, at the same time that the Chinese government was reforming its state owned enterprises (SOEs). This SOE reform stripped away from the SOEs, and then systemized, the various social welfare functions that the SOEs had been performing outside of their main corporate activity. In the area of social security, China began building a pension system in 1991, an effort that included the government's promotion of corporate pensions.[1]

Corporate pensions are expected to fill three roles. Their first role is to alleviate the burden on the basic pension system created by China's rapidly aging population.[2] China's population is aging at a rapid pace, and those aged 60 and older are expected to comprise 18% of the total population by 2026. The pension system introduced in China in the 1990s was a three-pillar arrangement based on 1) the basic pension system,[3] enrollment in which is compulsory, 2) corporate pensions, for which enrollment is voluntary, and 3) personal savings. When the pension system was designed in the 1990s, it was envisioned as replacing 90% of enrollees' incomes, with roughly 60% coming from the basic pension system, 20% from corporate pensions, and the remaining 10% from personal savings.[4]

Their second role is as a company benefit and incentive mechanism, so as to promote the sustained development of corporations. A third role is to foster the development of institutional investors that invest for the long term, and thereby promote development of the capital market.

Next, we look back at how corporate pensions have developed since the 1990s. This process started in 1991, when policies related to corporate pensions were put forward as part of pension reforms, as noted above. Specifically, Article 8 of the *Decision by the State Council on Reform of the Enterprise Employee Old Age Pension*

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1 Since then, China's social security system has primarily developed in urban areas. The system for urban areas is different than that for rural areas.

2 The three roles are as explained by the National Development and Reform Commission (2007).

3 Made up of personal accounts and a "social pool." For details, see Nomura Institute of Capital Markets Research (2007)

4 He, Ping (2007).

System provides that "supplemental corporate pension insurance shall be established by corporations for their employees, using their own economic resources..., while the government shall promote, and provide policy guidance regarding the implementation of supplemental pension insurance by corporations." It was this requirement that launched the introduction of corporate supplemental pension insurance, i.e. corporate pensions, which have been positioned as the second pillar of the pension system.

The *Notice of the State Council on Deepening of Reform of the Enterprise Employee Old Age Pension System*, issued in 1995, held that corporations, after collecting basic pension insurance premiums in accordance with regulations, can establish supplemental pension insurance under the State Council's policy directives, based on the business conditions at said company.

Likewise in 1995, the Ministry of Labor and Social Security (MLSS) issued the *Notice Regarding Printing and Distribution of the 'Opinion on the Establishment of an Enterprise Supplementary Old Age Pension System'*, which provided a basic framework for establishing supplemental pension insurance, including basic terms, decision-making procedures, financing, management methods, benefits, the institutions to be involved, and fund management. The notice also made it clear that corporate supplemental pension insurance is to be based on the defined contribution (DC) format.[5] Furthermore, it stated that the institutions that would administer the corporate pensions established pursuant to the *Opinion* would be the social security agencies of regional governments, industry-specific organizations and corporations, and commercial insurance companies. In fact, there appear to have been a large number of corporate pensions that were managed by social security agencies and industry-specific organizations. Initially, industry organizations also used to manage the basic pension insurance for each industry, but basic pension insurance was subsequently transferred to the social security agencies of local governments, leaving the industry organizations to specialize in corporate pensions.

Although the corporate pension system was established as noted above, as of the end of 2000 only 5.6 million people were participating in a corporate pension, a mere 5.4% of the number of people enrolled in the basic pension system. Corporate pension plans were primarily established in the wealthy coastal regions and in the wealthier industries, including electric power, oil, petrochemicals, air transportation (civil), telecommunications, and railroads.[6]

One of the reasons that corporate pensions were not more widely implemented is that although they were proposed as the second pillar of the system early on, corporations never viewed corporate pensions as mandatory, seeing them instead as something to be implemented voluntarily when they could afford to do so. Secondly, in many regions and industries there have been no specific laws implementing corporate pensions, nor have any tax incentives been established, while administrative rules vary widely depending on the region and the industry, with no existing individual accounts in some cases. Pension accounting rules are also lacking in

5 National Development and Reform Commission (2006)
6 He, Ping (2007)

consistency. Thirdly, it had already become apparent in 2000 that the basic pension system was underfunded, making it necessary to divert funds meant to be saved in the basic pension system's individual accounts in order to pay for the benefits of retirees. In some regions, the social security agencies even had to divert funds from corporate pensions in order to pay basic pension system benefits. This fomented concerns over the idea of the regional social security agencies handling corporate pensions. Even in the case of corporate pensions managed by large corporations, there were problems with the co-mingling of a corporation's other assets with corporate pension assets. A fourth problem was the lack of expertise in fund management and related areas.[7]

In response to these issues, considerable progress has been made on the legislative front since 2000, when the State Council announced its *Trial Plan to Improve the Urban Social Security System*. It was under this proposal that corporate supplemental pension insurance plans were renamed corporate pensions. Companies that meet the requirements are able to establish corporate pensions, which are defined contribution plans with individual accounts to which both the corporation and the employees contribute. The proposal also made it clear that corporate contributions up to 4% of total wages could be deducted from the corporation's taxable income. Liaoning was one of the provinces chosen to try the program out on a trial basis.

In 2001, three requirements were stipulated for a company to establish a corporate pension: the company must (1) participate in the basic pension system, and pay premiums on time, (2) have stable production/business, and relatively strong corporate earnings; and (3) have a sound system for internal controls.[8]

In 2004, the MLSS announced the *Trial Measures for Enterprise Annuities*, while the *Trial Measures for the Management of Enterprise Annuities Fund* was announced jointly by the MLSS, the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC). Both laws required that pensions be managed by qualified trustees (asset managers), record keepers, custodians, and investment management companies, and filled out the framework for a trust-based corporate pension system. The administration of corporate pensions, previously handled by the social security agencies of regional governments, must be transferred to these qualified institutions, as explained in more detail below. Following publication of the two laws, more detailed rules and procedures were established through notes and other means.

[7] This paragraph references Otsuka and Japan Center for Economic Research (2002) and Hu (2006)

[8] National Development and Reform Commission (2007)

II. Corporate pension framework

1. Basic framework

We look here at the current framework for China's corporate pension rules, based on the two pension laws implemented in 2004: *Trial Measures for Enterprise Annuities (Order No. 20 of the Ministry of Labor and Social Security)* and *Trial Measures for the Management of Enterprise Annuities Fund (Order No. 23 of the Ministry of Labor and Social Security*).

As noted above, corporate pensions in China are established voluntarily by corporations and employees (officers and workers) as supplemental pensions, predicated on participation in China's basic pension system. *Article 2 of Order No. 20 of the MLSS on Trial Measures for Enterprise Annuities* (20-2) states that a company can establish a corporate pension, provided that it (1) participates in, and pays premiums for, the basic pension system, (2) has the ability to bear the economic cost, and (3) has a mechanism for collective bargaining (20-3). Requirement (3) is necessitated by 20-4, which states that corporate pensions shall be established upon consultation between the company and the union or employee representative.

A corporate pension proposal must include (1) the employees eligible to participate, (2) the method of funding, the methods for (3) administering individual accounts, (4) administering the funds, and (5) calculating and making payments, (6) the conditions for payments, (7) the approach for administration and oversight, (8) conditions for suspending contributions, and (9) other items that must decided by both the company and employees (20-5). Compliance with these requirements is checked closely when establishing a corporate pension.

In addition, corporate pensions must be of the defined contribution type, offer management of individual accounts (20-10), and allot investment returns to those individual accounts. Individual accounts must be transferable to the new employer when changing jobs (20-13), i.e., must have "portability."

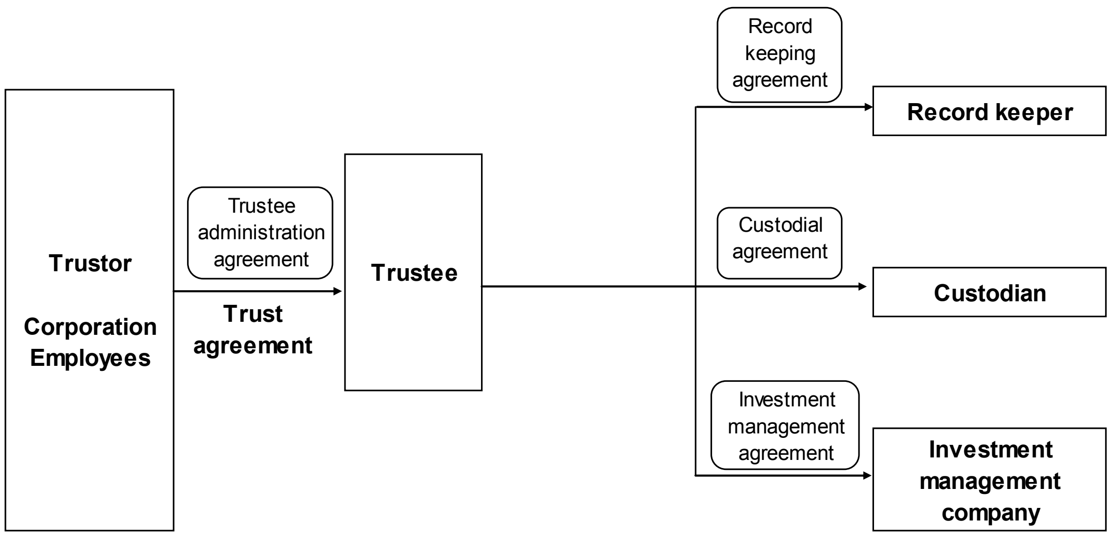
On the contribution side, corporations and employees must make joint contributions (20-6), the company's contribution cannot exceed 1/12 of an employee's total wages of the previous fiscal year, and the total contribution by company and employee together cannot exceed 1/6 of an employee's total wages of the previous fiscal year (20-8). Benefits are to be paid after retirement, either in a lump sum or in installments (20-12).

2. Institutions that administer and manage corporate pension assets

The administration and management of corporate pensions, in light of the pension management issues noted above, is organized so as to provide a clear division of duties among the trustees, record keepers, custodians, and investment management companies, providing for a system of mutual checks and balances.

Companies that establish a corporate pension must first designate a trustee to entrust with managing the corporate pension fund. The company and the trustee are in a trustor/trustee relationship. The trustee is either the corporate pension fund council established by the company or the corporate trust institution that satisfies state regulations (20-15). The corporate pension council consists of corporate and employee representatives (at least one third of the council). The trustee can outsource the pension's record keeping to a qualified corporate pension record keeper, investment management to a qualified investment management company, and custodianship to a qualified commercial bank or specialized custodial institution (custodian) (20-19). The relationship between the trustee and the record keeper, investment management company, and custodian is an outsourcing relationship (Figure 1).

Figure 1: Contractual arrangement of corporate pensions



Source: Nomura Institute of Capital Markets Research, based on Yang and Zou (2006a)

We look next at the specific duties of the trustee, record keeper, investment management company, and custodian.

The trustee is responsible for (1) selecting, supervising, and changing the record keeper, custodian, investment management company, and the intermediary service providers (investment advisors, accounting firms, and law firms); (2) setting the fund's core investment strategy[9]; (3) preparing administrative reports and financial accounting reports; (4) collecting contributions from the employer and employees per agreement and distributing pension benefits to beneficiaries (persons qualified to receive pension benefits); (5) submitting to examinations by trustors (the corporation and employees) and beneficiaries, submitting fund management reports to trustors, beneficiaries, and regulatory authorities, and, in the event of a serious event, submitting reports to trustors, beneficiaries, and regulatory authorities as necessary (Article 13 of *Order No. 23 of the MLSS on Trial Measures for the Management of Enterprise Annuities Fund* (23-13)). The requirements to qualify as a trustee include having registered capital of at least Rmb100 million and net assets of at least Rmb150 million (23-12). In addition, the trustee's management fee must be no more than 0.2% of the net assets of the corporate pension fund being managed by the trustee (23-53).

The record keeper is responsible for (1) opening accounts for the corporation and individuals; (2) keeping a record of employer and employee contributions and of investment returns; (3) reconciling data on contributions and changes in corporate pension accounts with the custodian; (4) calculating corporate pension benefits; and (5) periodically submitting reports on fund account administration to the trustee and regulatory authorities (23-21).The requirements to qualify as a record keeper include registered capital of at least Rmb50 million (23-20). In addition, the recordkeeping fee shall be no more than Rmb5 per account per month (23-54).

The custodian is responsible for (1) securely storing corporate pension fund property; (2) opening a cash account and securities account for the fund property under the name of the corporate pension fund; (3) opening separate accounts for the property of other corporate pension funds under its custody; (4) distributing fund property to the investment management company on instructions from the trustee; (5) liquidating and settling as appropriate on instructions from the investment management company; (6) calculating and estimating fund accounts; (7) reconciling related data with the record keeper and the investment management company and supervising investments made by the investment management company; (8) periodically submitting fund custodian reports and financial accounting reports to the trustee; and (9) periodically submitting fund custodian reports to the regulatory authorities (23-27). The requirements to qualify as a custodian include having net assets of at least Rmb5 billion (23-26). In addition, the custodian's management fee must be no more than 0.2% of the net assets of the pension fund in custody (23-55).

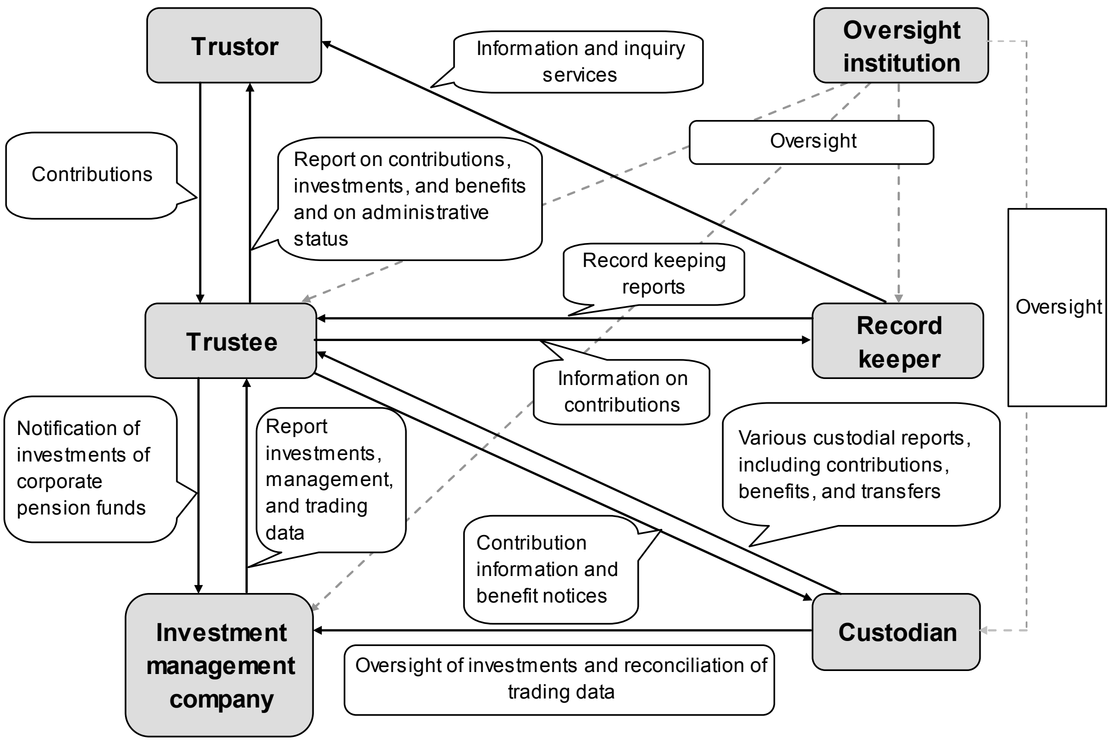
The investment management company is responsible for (1) investing the corporate pension fund property; (2) reconciling the fund's account calculations and estimates with the custodian; (3) establishing reserves for the fund's investment management risk; and (4) periodically submitting investment management reports to the trustee and the regulatory authorities (23-35).

9 The investment manager actually invests according to the investment strategy established by the trustee. Employees are not allowed to directly choose investment products.

The requirements to qualify as an investment management company are, for securities firms, at least Rmb1 billion in both registered capital and net assets, and for fund management companies, trust & investment companies, insurance asset management companies, and other specialized investment institutions, at least Rmb100 million in both registered capital and net assets (23-34). In addition, the same institution (or institutions with cross-held equity or shares) cannot serve as both an investment management company and custodian (23-45). The management fee received by the investment management company must be no more than 0.2% of the net assets of the corporate pension fund being managed (23-56).

The system is thus designed to ensure mutual checks and balances among the trustee, record keeper, investment management company, and custodian (Figure 2).

Figure 2: Relationships among corporate pension players



Source: Nomura Institute of Capital Markets Research, based on Yang and Zou (2006a)

In August 2005, the MLSS announced a list of institutions qualified to administrate and manage corporate pensions. The first list included 29 institutions and 37 qualifications. A second list, announced in November 2007, included 18 institutions and 24 qualifications (Figure 3).

Figure 3: Institutions that administer and manage corporate pension assets

	Custodian	Trustees	Recordkeeper	Investment management company
Banks	Industrial & Commercial Bank of China	Industrial & Commercial Bank of China	Industrial & Commercial Bank of China	
	China Construction Bank	China Construction Bank	China Construction Bank	
	China Merchants Bank	China Merchants Bank	China Merchants Bank	
	Bank of Communications		Bank of Communications	
	China Everbright Bank		China Everbright Bank	
	Bank of China		Bank of China	
	China CITIC Bank			
	Shanghai Pudong Development Bank		Shanghai Pudong Development Bank	
	Agricultural Bank of China			
	China Minsheng Banking		China Minsheng Banking	
Insurance companies			China Life Insurance	China Life Asset Management
		China Life Pension	China Life Pension	
			Taikang Life Insurance	
		Taikang Pension & Insurance	Taikang Pension & Insurance	Taikang Asset Management
		Ping An Annuity Insurance	Ping An Annuity Insurance	Ping An Annuity Insurance
			China Pacific Life Insurance	
		Taiping Pension		Taiping Pension
				PICC Asset Management
				Huatai Asset Management
		Changjiang Pension Insurance	Changjiang Pension Insurance	Changjiang Pension Insurance
			Xinhua Life Insurance	
Trustees		CITIC Trust & Investment	CITIC Trust & Investment	
		Fortune Trust	Fortune Trust	
		China Credit Trust		
		Shanghai International Trust Co.		
Fund management companies				China Southern Fund Management
				Bosera Funds
				China AMC
				Harvest Fund Management
				Fullgoal Fund Management
				E Fund Management
				Yinhua Fund Management
				China Merchants Fund Management
				Fortis Haitong Investment Management
				Guotai Fund Management
				ICBC Credit Suisse Asset Management
				GF Fund Management
Securities firms				CITIC Securities
				China International Capital

Note: Shaded areas denote companies on second list (see main text).
Source: Nomura Institute of Capital Markets Research, based on various news reports

There are some financial institutions on this list receiving three qualifications (including for group members). Future lists may include new combinations in addition to the 2+2 (one company serves as both trustee and investment management company, and another bank serves as both custodian and record keeper) seen on the first list, such as a 3+1, in which all of the functions except for custodian are handled by the same financial group, or likewise, all of the functions except for investment management are handled by the same financial group. As we note below, a key area to watch will be whether the system of mutual checks and balances functions even under a 3+1 arrangement or when the same institution serves as both trustee and investment management company.

3. Investment of corporate pensions

We look here at the investment of funds by the investment management company. To begin with, corporate pensions must limit their investments to bank deposits, government bonds, and other highly liquid financial products, which include short-term bond repos, bank debentures and corporate bonds with an investment grade or better, convertible bonds, investment-type insurance products, mutual funds, and equities (23-46). The maximum investment in each of these products is as follows, with percentages calculated based on market values.

(1) Investments in money market funds and liquid products such as bank demand deposits, central bank bills, and short-term repos shall not drop below 20% of the corporate pension fund's net assets.

(2) Investments in bank time deposits, "negotiated" deposits, government bonds, bank debentures, corporate bonds and other fixed-rate products, as well as convertible bonds and bond funds, shall be no more than 50% of the fund's net assets, while investments in government bonds alone shall not drop below 20% of net assets.[10]

(3) Investments in equities, investment-type insurance products, and equity funds shall be no more than 30% of the fund's net assets, while investments in equities alone shall be no more than 20% of net assets (23-47 for all of the above).[11]

When a corporate pension managed by a single investment manager invests in a stock issued by a single corporation or in a mutual fund, the amount of that investment shall not exceed a total share of 5% of said stock or said mutual fund, nor shall exceed 10% of total pension fund assets managed by the investment manager (23-49).

Corporate pension funds are prohibited from being used for margin trading, lending, or collateral (23-51). Also prohibited are the comingling of the investment manager's property with the corporate pension's property, unequal treatment of other

[10] Since 31 January 2007, corporate pensions have been allowed to participate in the interbank bond market.

[11] Because the basic pension system is limited to investing in bank time deposits and government bonds, corporate pensions actually have greater latitude in investing their funds.

corporate pension funds managed by the investment manager, and the diversion of corporate pension property (23-40).

4. Tax rules

We look next at the tax treatment of corporate pensions at each level: making contributions, generating investment returns, and receiving benefits.

As already noted, the State Council's *Trial Plan to Improve the Urban Social Security System* in 2000 authorizes a tax deduction for corporate pension contributions up to 4% of wages. This only applies, however, to Liaoning and other provinces where the *Trial Plan* is being applied on a trial basis. Only a small number of companies have actually used this program.[12] In other regions, deductions were apparently allowed up to a certain percentage of total wages, depending on conditions in that region, based on the Ministry of Labor and Social Security's 1995 *Opinion on the Establishment of an Enterprise Supplementary Old Age Pension System*.[13] Later, based on a 2003 *Note* from the Ministry of Finance, corporations in other regions were also allowed in principle to deduct up to 4% of their contributions; at this point, however, the incentive tax rates differ by region (Figure 4).

Figure 4: Tax deductions in each region

(% of total wages)

Province (City)	Maximum deduction	Province (City)	Maximum deduction
Wuxi	12.5%	Sichuan	4%
Hubei	12.5%	Shaanxi	4%
Shanxi	8.3%	Shandong	4%
Chongqing	6%	Qinghai	4%
Tibet	4-6%	Ningxia	4%
Zhejiang	5%	Liaoning	4%
Yunnan	5%	Jilin	4%
Shenzhen	5%	Hunan	4%
Shanghai	5%	Heilongjiang	4%
Guizhou	5%	Hebei	4%
Fujian	5%	Guangzhou	4%
Anhui	5%	Gansu	4%
Xinjiang	4%	Beijing	4%
Tianjin	4%		

Note: For corporate income taxes, denotes the maximum employer contribution that can be deducted from taxable income (see main text).

Source: Nomura Institute of Capital Markets Research, based on page 88 of "Zhongguo Qiye Nianjin Guifan yu Fazhan (China Enterprise Pension Regulation and Development)," published by China Industry and Commerce Associated Press, 2007

12 Hu (2006)

13 Hu (2006), Yang and Zou (2006b)

There was no mention of employee contributions in the *Trial Plan*, nor have other notes included any tax incentives.

There are no tax breaks on the investment returns of corporate pensions, and because corporate pension benefits do not receive any special treatment under individual income tax rules, individuals must pay income tax on the benefits that they receive.

Using the letters E for exempt and T for taxed for each stage -- contribution, investment returns, and benefits -- China's corporate pension taxation is currently ETT on the corporate side and TTT on the individual's side.[14]

5. Oversight

The main governmental agencies charged with the oversight of corporate pensions are the MLSS, the CSRC, the CIRC, and the CBRC. The MLSS is responsible for setting policy on the administration of corporate pensions, while administrative units of the MLSS handle the supervision and administration of corporate pension fund management (23-9). In addition, the CSRC, the CIRC, and the CBRC supervise and administer financial institutions involved in corporate pensions, based on the industry segments they are responsible for. For example, if a financial institution wants to be qualified as a trustee or investment manager, it must receive approval from the relevant regulatory body prior to applying with the MLSS. Because various categories of financial institutions are involved with corporate pensions, governmental administration is shared in accordance with the industry segment.

III. Trends and issues since publication of the two laws in 2004

1. Transferring corporate pensions established under the old system to the new system

As of the end of 2006, 24,000 corporations had established a pension, 9.64 million employees were paying into these pensions, and total fund assets stood at Rmb91 billion. By the end of 2007, these assets appear to have grown to over Rmb130 billion.[15]

As also evident from the events leading up to the development of corporate pensions, two pension tracks exist side by side, those established prior to publication of the two laws in 2004, and those established after. Of the total corporate pension

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14 Under the basic pension system, both the employer contribution and the employee contribution are deductible. In addition, the individual pays no income taxes on benefits received.

15 MLSS, Department of Fund Supervision. *China Securities Journal*, dated 23 November 2007.

assets of Rmb91 billion at the end of 2006, only Rmb20 billion is managed by funds established under the two 2004 laws.[16]

In response, the MLSS announced its *Opinion on the Takeover of Pre-existing Enterprise Pensions* in April 2007. This opinion provided for the transfer of corporate pensions that had been managed by social security agencies, industry organizations, and individual corporations to the institutions noted above that are qualified to manage corporate pensions. Prior to the transfer, portfolios were rebalanced to meet the investment criteria of the two laws, and if there was any nonperforming asset it was disposed of after clarifying responsibility.[17] In principle, the deadline for this transfer was the end of 2007, although the deadline was extended until the end of 2008 for those SOEs run by the central government (CSOEs) that could show the MLSS that they would have difficulty meeting the 2007 deadline.

This decision provoked competition among the financial institutions in each region to win contracts on corporate pensions established under the old system. A number of these transitions occurred in 2007, one of which was the corporate pension run by the city of Wuxi in Jiangsu province. Its over Rmb700 billion in assets and over 6,000 plan participants were turned over to Taiping Pension as trustee and investment management company, to the Industrial & Commercial Bank of China as record keeper, and to the Bank of China as custodian. In addition, Changjiang Pension Insurance became trustee for the over Rmb15 billion corporate pension of Shanghai City's Corporate Pension Management Center, while both Taiping Pension and Ping An Annuity Insurance are now trustees of over Rmb34 billion in assets for Jilin province.

The first CSOE to transfer its corporate pension was Dongfeng Motor in August 2007, with the Dongfeng Motor Corporation Enterprise Pension Trustees the trustee, the Industrial & Commercial Bank of China as custodian, the China Merchants Bank as recordkeeper, and three investment management companies: China Life Asset Management, Bosera Funds, and Harvest Fund Management.

Following release of the *Opinion on the Takeover of Pre-existing Enterprise Pensions*, the State-Owned Assets Supervision and Administration Commission (SASAC) announced its *Notice Regarding Trial Implementation by Central Government Enterprises of Enterprise Pension Systems* in September 2007. This *Notice* prohibited the establishment of a corporate pension by CSOEs reporting a loss on their consolidated financial statements or CSOEs that do not maintain or increase the value of state-owned capital. The initial trial for corporate pensions required that employee contributions be at least 25% of corporate contributions, and this amount was gradually raised to 100%. Pre-existing corporate pensions must be modified and standardized, and proposals for a new corporate pension drafted, as soon as possible, and auditing paperwork must be submitted to the SASC no later than June 2008. As

16 MLSS, Department of Old Age Pensions. *China Securities Journal*, dated 10 September 2007.

17 The big scandal that erupted at Shanghai Labour and Social Security Bureau in 2006 also included the unlawful investment of funds misappropriated from corporate pensions.

noted above, under extenuating circumstances this deadline can extended until the end of 2008.

CSOEs are expected to provide a role model for the expansion and standardization of corporate pensions. In reality, however, with the exception of companies in profitable, monopolistic industries like electric power, petrochemicals, crude oil, and telecommunications, the CSOEs do not necessarily have a very strong commitment to establishing corporate pensions, owing to cost considerations and the lack of transparency regarding tax treatment. We think that the *Opinions of the State Council on the Pilot Implementation of the State Capital Operating Budget* announced in September 2007, which requires CSOEs to distribute profits to the Ministry of Finance, will also raise the cost consciousness of CSOEs.

Meanwhile, an initial group of three financial institutions, the Bank of China, China Everbright Bank, and PICC Property and Casualty, were authorized on 7 February 2007 to establish corporate pensions under the new system based on the two 2004 laws. The three are China's flagship state-owned commercial bank, joint stock commercial bank, and nonlife insurance company, respectively. Lenovo, the company that acquired IBM's PC business, received approval to establish a corporate pension in July 2006, and a number of other companies have established corporate pensions since then.

2. Competition among financial institutions is heating up

In February 2008, the CIRC published the operating data of annuity insurers for the first time ever, showing total assets held in trust by all of China's annuity insurance companies of Rmb8.4 billion, and total assets managed for investment of Rmb7.97 billion. The leading annuity insurer was Ping An Annuity Insurance, with Rmb4.98 billion in assets held in trust, and Rmb5.05 billion as investment manager. One reason for Ping An's lead is that it has captured over an 80% share of Shanghai City's corporate pension market, which quintupled in size in one year.[18] When Liaoning province began experimenting with the transition from the old system to corporate pensions in 2004, second-ranked Taiping Pension took over the pensions for companies affiliated with the province, and this gave it an early start in developing its corporate pension business.

A second list of financial institutions approved to handle corporate pensions was announced in November 2007 (Figure 3), and with the addition of banks as approved trustees there is now a three-way competition in the trustee segment among banks, insurers, and trust banks. Insurance companies and fund management companies now compete for business in the investment management segment.[19]

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18 *Jfdaily.com*, dated 16 February 2007.

19 Of the 36 companies signing agreements with investment management companies in 2006, 27 selected fund management companies. Ba (2007).

IV. Future challenges and risks

1. Growing size of corporate pensions

Although the number of participants in corporate pension plans, 9.64 million at the end of 2006, has grown over the past few years, it is still miniscule compared with the 187.66 million enrolled in the basic pension system (including 46.35 million retirees), and corporate pensions still have a long way to go before they can be called the second pillar of China's pension infrastructure.

Various challenges remain in achieving growth in corporate pensions. To begin with, corporate pensions remain fairly unknown. Both corporations and employees lack basic knowledge of the significance of corporate pensions, how they are organized, and what their benefits are. Although the authorities have positioned corporate pensions as the second pillar of China's pension system, corporate management does not appear to feel compelled to implement the plans. An MLSS survey found that only about 40% of corporate management were aware that corporate pensions existed, and of those, only about 30% truly understood corporate pensions. One in three managers thinks that companies have no responsibility for corporate pensions.[20]

In a survey of pension-qualified fund management companies, a majority answered that the current difficulty in developing the corporate pension market is owing to a lack of awareness among corporations, and that a strengthening of promotional and educational efforts is needed. This lack of awareness was thus identified as the biggest issue standing in the way of developing corporate pensions.[21]

A second problem is the lack of tax incentives. As noted above, only the employer contribution is tax deductible, and even this varies across regions. These regional differences may further complicate the challenge of setting up a corporate pension plan, and of ensuring that plan's portability, for those companies that operate nationwide.

In addition, because the employee's contribution is not tax deductible, there is no tax incentive for individuals to contribute. Thus the market is waiting for the government to announce a nationally uniform set of tax incentives for corporate pensions that apply at every level: employer and employee contributions, investment returns, and benefit payments.

Officials at China's State Administration of Taxation (SAT) have announced their thinking on the direction of tax incentives,[22] as follows. Corporate contributions to pensions should be deductible from taxable corporate income, but certain restrictions would be added to prevent the use of these deductions for tax evasion. For individual income taxes, (1) employee contributions can be deducted from taxable income; (2) although employer contributions are added to individual accounts, they are not

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20 Based on a survey by the MLSS. National Development and Reform Commission (2007).
21 Based on a survey by Ping An Securities. Ba (2007).
22 Proposal by the Chief of the Tax Law Department, SAT. *Securities Times*, dated 10 September 2007.

recognized as current income for the individual and thus not taxed; (3) investment returns, while also added to individual accounts, would also be tax-free for an extended period; (4) Withdrawals made by retired employees from their individual pension accounts are to be taxed as wage income.

Thirdly, few small and medium-sized enterprises have established a corporate pension. According to the MLSS, only about 50 such companies had established a corporate pension as of the end of 2006, amounting to less than Rmb100 million, under 1% of the corporate pension market. The procedures for establishing and operating a corporate pension are the same for all companies at this time, but the income earned by the firms administering corporate pensions is determined by the size of the fund. This makes the administration of corporate pensions for small and medium-sized enterprises relatively more costly, and explains why the firms that administer corporate pensions are not very keen on handling the plans of smaller companies.

Because of this, it appears that in 2007 the MLSS sent its *Draft Measures for Regulation of Enterprise Collective Pension Schemes* (discussion draft) to certain financial institutions to obtain their feedback. The *Draft Measures* attempt to solve the problem noted above by having numerous smaller firms (corporate pension trustors) sign an agreement with a single trustee to manage their funds collectively. To manage risk, three different investment management companies must be selected. This differs from the *Trial Measures for Enterprise Annuities* and the *Trial Measures for the Management of Enterprise Annuities Fund* currently in force.

Tax incentives would probably be effective in this regard, as well. A more solid corporate pension plan can help to attract talent, thereby promoting the development of small and medium-sized enterprises over the long term. It is therefore conceivable that additional incentives may be given for the pension plans of small and medium-sized enterprises, over and above the tax breaks for corporate pension plans in general.

2. Potential risks

There are also potential risks with the system of checks and balances among the institutions that administer corporate pensions.

As already noted, the trustee plays a critical role based on how a corporate pension is organized. There are doubts over the trustee's ability to provide checks, however, given the situations that have actually arisen thus far.[23] These include investment managers not following the rules when investing, and, amid increasingly intense competition, the investment management company being selected first after the corporate pension plan is established, with the investment management company then selecting the trustee, which is the reverse of the required order. Likewise, there are also examples of the trustee making investments without using an investment management company. All of these situations are problematic in relation to the safety of corporate pensions.

[23] Guo (2007)

It has also been noted that trustees are compensated poorly in view of the importance of their role and responsibilities. Trustees' management fees are limited to no more than 0.2% of the fund's net assets, but because of intense competition, few trustees are able to receive 0.2%, and in some cases the trustee receives no fees at all.[24] Because the trust business provides little income, some financial institutions are starting to serve as trustee as well record keeper and investment manager. In fact, combination roles such as this 3+1 have been possible since the second list of corporate pension service providers was announced. This creates the risks that checks and balances will not function as well within a single financial institution, and that profits will be shifted and transfer prices manipulated. The same is true when the trustee selects a record keeper or investment manager from within the same financial group. The custodian is expected to function as the "checker" in these cases. It has been noted, however, that the custodian does not incur a responsibility to the trustor (employees and the corporation) solely by virtue of an agreement concluded with the trustee.[25]

In this situation, it is not always clear which party is responsible in the event that the corporate pension suffers a major loss or is involved in serious misconduct. Even when the trustee, who signs a trust agreement with the trustor (employee and corporation), has responsibility, it is a separate issue whether the trustee has the wherewithal to pay damages. If a corporate pension were to fail, it would raise mistrust of corporate pensions and hinder their development. A bailout by the local government would create a moral hazard, however, as well as the risk of the funds being unlawfully managed.

It basically boils down to the same problems with China's financial system that have been identified in other contexts, which are its underdeveloped financial institution management and capital markets, as well as the inadequate enforcement of, and compliance with, laws and regulations. This makes government oversight and administration important for the time being.

3. Oversight and administrative issues

As already noted, the oversight of corporate pensions is handled by the MLSS as well as the financial institution regulatory bodies: the CBRC, CSRC, and CIRC. In addition, the Ministry of Finance is involved with accounting issues, the SAT with tax issues, and the SASAC with issues involving the administration of state-owned assets. Similar regulations are issued by multiple governmental agencies, all of which appear to be competing amongst themselves.[26]

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24 Ibid

25 Yan (2007)

26 There were reports of a dispute between the MLSS and the CIRC regarding oversight authority. Han (2007).

Although the MLSS[27] appears to be taking the lead role in oversight for now, it is not set up to supervise and manage the risk of financial institutions, and this suggests there may be a need to either create a new regulatory body specifically for corporate pensions, or establish a committee or other coordinating mechanism among the oversight agencies. It would be desirable to expand the supervisory staff within the MLSS.

Looking beyond just the corporate pension segment, as China's financial institutions increasingly form conglomerates, the need will arise to improve upon the current system of dividing oversight by industry segment. This is likely to become a particularly large problem in the case of corporate pensions, given the many types of financial institutions that are involved.

V. Conclusion

China's corporate pension plans have begun to operate under new rules. Corporate pensions established under the old rules began shifting to the new rules in 2007, when a second list of approved corporate pension service providers was announced. Assets held in corporate pension plans appear to have grown by over Rmb40 billion in 2007, and we expect to see further growth over the long term.[28]

From the capital markets perspective, rules that prevented corporate pensions from participating in the nationwide interbank bond market were lifted in January 2007. During 2007, there were 94 corporate pension plans that subscribed to IPOs or other stock offerings. Corporate pensions are beginning to establish a market presence as institutional investors, and this presence is expected to gradually increase. Some observers also expect corporate pensions to invest overseas.

Although expectations are high, in order for growth in corporate pensions to meet these expectations, it will probably require that corporations and their employees become more aware of the plans, and that the appropriate tax incentives also be adopted. We also see a need to improve regulatory oversight so as to strengthen the checks and balances among pension plan participants and service providers and thereby lower the risks.

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27 The institutional reforms of March 2008 combined the MLSS and the Ministry of Personnel to form the Ministry of Human Resources and Social Security.

28 The World Bank forecasts China's corporate and organizational pensions will grow to $1.8 trillion (approximately Rmb12.8 trillion) by 2030.

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