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# **EU-China Social Security Reform Co-operation Project**

## **for The People's Republic of China**

***The Regulation of Public and Private Pensions in China: A  
Policy Note***



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## **The Regulation of Public and Private Pensions in China: A Policy Note**

### Purpose of the Note

The purpose of this note is to suggest possible ways forward for the development of supervision of public mandated and private pensions in China. There is a substantial body of literature publicly available on the Internet on the theory of supervision and the practical experience of a significant number of OECD and developing countries in implementing pension supervision. It is not therefore the purpose of this note to synthesize or summarize this. There is however a need to examine policy choices for China in the context of present and likely future development of the pensions system and China's existing regulatory systems for the financial services industry. The note examines five key questions as to the development of the regulation of pensions and makes appropriate linked recommendations

The main focus of the note is on enterprise annuities or occupational pensions (pillar 3 in World Bank Pension taxonomy). However it also considers the regulation of three other elements of the current pension system – the mandatory pay as you go social pool element of the urban system (pillar 1 in World Bank Taxonomy), the mandatory individual account element of the urban system (pillar 2), and rural individual account pensions of a currently non-mandatory character but sponsored and managed by government (pillar 3).

### Question 1 Should there be a separate regulator for pensions?

The principal argument in favour of a separate regulator is that the sponsor function for the provision of pensions (demand side) is different from the provider function of financial products and services that help to deliver the pension return. In a world where pensions are all provided under defined contribution pension plans supplied by financial service institutions, this distinction largely breaks down – although those consultants and firms who advise the organizers still need to be regulated separately from the financial service institutions. However in a world where there is a mixed economy of defined benefit and defined contribution, and options for enterprises to undertake direct investment of pension funds, the regulation of pension sponsoring bodies clearly represents a different regulatory task

The main contrary arguments in favour of a unified regulator are two fold. The first is the potential for information sharing and mutual learning among regulatory bodies particularly where financial institutions provide multiple financial services (such as banking, securities and insurance contracts). Since regulation should be concerned with institutional regulation more than product regulation (which may be both ineffective and constrain innovation), the possibility exists of both overlapping mandates and an absence of any coverage in some areas. Institutional silos may also hinder effective cooperation and networking across different regulatory bodies.

The second argument for unified supervision is economies of scale. In many small countries it is simply inefficient to have a number of different regulatory bodies, with the need for their own senior management and governance structures, office buildings and other overheads. It may also be difficult to justify recruiting highly specialist expertise which is needed but may not be fully employed; and staffing levels may simply be inadequate to carry out effective supervision. In this situation, (more) unified supervision allowing for recruitment of larger teams, more specialist staff and operating on risk management principles may offer more effective regulation than smaller bespoke bodies.

If we look at China what do we see? On the sponsor side there are three major phenomena:

- 1) The potential scale of the market is huge, even if the market is currently very under-developed. In the next few years as China's working population bulges and record numbers of college graduates enter the market, there is likely to be downward pressure on wages and perhaps only a limited number of employers will look at offering occupational pension schemes. Nevertheless competition for highly skilled and experienced staff, is already underway in some of the richer provinces; and as more foreign funded firms seek to set up Joint Ventures or even enter the market in their own right, they are likely to see pensions as a key element of any remuneration package. In other words, enterprise annuities the core of likely Pension Regulator work, are likely to grow sufficiently rapidly to justify an independent regulator.
- 2) While it is likely that, in the short term, most enterprises would opt for some forms of defined contribution schemes, possibly investing in plans provided by the big commercial companies, this cannot be taken as a given particular if investment returns are significantly below GDP and corporate profit growth. It is perfectly possible that companies may opt for defined benefit schemes and seek to manage their own investments. Or they could offer minimum return defined contribution schemes, partly self invested and partly invested in commercial plans. It is also worth noting that current enterprise annuity regulations do not prohibit self-investment, nor do they adequately define single organisational groups for the purpose of quantitative restrictions. Finally the tax incentive structure, with no incentives to individuals, does not promote sponsorship of employee sponsored personal pension plans, and companies may be unlikely to favour products that will promote labour mobility. Thus there can be no presumption that DC commercial planned schemes will predominate; there will be enough work to monitor pension sponsors
- 3) The corporate governance of many likely enterprise annuity sponsors is very weak and characterised by poor financial accounting and reporting, inadequate internal controls and weak (or non-existent) governing bodies. In other words no reliance at all can be placed on the corporate governance of enterprises to provide corporate governance for enterprise annuities. Even if

much more comprehensive regulations are adopted, there will be a need for strong and effective oversight of their implementation by sponsors and sponsors' relations with potential providers.

If we look at the supply side, we see already that given the potential size and volume of respective market segments, China has already opted to split regulatory responsibilities between three bodies – insurance (CIRC), securities (CSRC) and banking (CBRC). While pensions would most likely to be allocated to the CIRC, if it came down to a choice between existing regulators, it is still possible that regulation of pension plans would involve aspects belonging to the other two bodies. The danger of a niggling 'turf war' cannot be excluded. Furthermore as new fledgling organisations, all three commissions are only slowly finding their feet and have significant work to do addressing urgent needs in their own field. Allocating them additional responsibilities in the field of pension regulation may cause them to take their eye off the ball in their own field while not giving proper attention to a new field in which activity is only slowly emerging.

Finally having a pensions regulator subordinate to the Ministry of Labour and Social Security would emphasize MOLSS's role in the pensions policy 'nexus'. On the one hand, it is the principal proponent of pension policy, and on the other through its arms length regulatory institution, it would have a key handle on the implementation of policy. The Regulator would also be able to offer important policy related advice as the Irish Pensions Board does for example. This would leave the MOF to supervise (through its arms lengths commissions<sup>0</sup> the financial institutions and service providers.

## Question 2 What should come under the Pension Regulator's remit?

Clearly there is potentially enough in the enterprises annuities segment of the market to justify having a Pensions Regulator. But there are potentially three other main schemes that could also come under the remit:

- a) Social pool PAYG pension funds operated by provinces, municipalities and counties
- b) Individual accounts, operated by the same authorities which are notional in most areas of the country, but which have been part consolidated in the 3 NE provinces and since 2006 in 8 other provinces
- c) Rural pension fund accounts, maintained on an individual account basis, some with but most without additional government and collective contributions and maintained by local government authorities

The Pensions Regulator could potentially have a role in regulating all three schemes not least because the Central Government and especially MOLSS is not directly involved in running them. The schemes are administered by LSSBs working as part of and accountable to the relevant sub-national government tier. Subjecting them to the operation of an arms length regulator may improve the quality of Ministry oversight, constrained as it currently is by the strict limitations on administrative staffing and operational budgets and the problems of geographical outreach.

However several things need however to be considered:

- 1). The number of separate schemes. At the moment there are a large number of separate PAYG pension pools and monitoring all of them may not be feasible, as is also the case for rural pension schemes. This is also theoretically true for individual accounts; albeit it is largely irrelevant given the limited nature of consolidation.
- 2) The nature of the schemes to be regulated. Individual accounts in both the urban scheme and potentially in the rural schemes are likely to be managed by external fund managers working on contract to the sponsoring bodies. In this sense the nature of the activity to be regulated is similar to that for enterprise annuities (except they are state as opposed to private sponsored) In contrast the social pool is akin to tax financed social transfers albeit payable on the basis of a contribution record.
- 3) The nature of current regulation. There is already in theory heavy regulation / audit of social pool expenditure from the Audit Bureau and Finance Bureau of the organising and supervising tier of sub-national government. It is probably more appropriate to streamline and make more effective this regulatory system rather than introduce another regulator. On the other hand, the regulation of individual accounts can be neatly sectioned off into the management of funds, the only issue being therefore whether the regulator should be involved in ensuring that contributions are earmarked properly to individual accounts or whether this should be left to the Audit authorities

Given the current concerns about the governance of public pension funds (including the rural system) and the influence that may be having on the pace and extent of consolidation, it would appear a logical step to extend the role of the Pension Regulator to the management of individual urban and rural accounts

### Question 3 What sort of structure should the Pension Regulator's Office have?

Broadly speaking it would appear logical to develop a single organizational structure operating through de-concentrated field offices based at provincial level. This would enable the Regulator's Office to have a direct counterpart relationship with the Provincial LSSB (which would become the most important body in the management of state pensions if the MOLSS policy of creating provincial level pooling is adopted). It would also enable the Regulator to establish relationships with other regulators based at the provincial level, particularly at CBRC. Given that most provinces in China are the size of medium or large countries, this will enable each provincial regulator's office to be adequately staffed and resourced.

It may be appropriate in the medium term to establish sub-offices in the biggest and most populous municipalities where there may be large numbers

of enterprise annuities (and potentially municipal management of urban and rural individual accounts). Similarly for a small number of the under-populated western provinces, it may be appropriate particularly at the start to have a Regional Regulator's Office.

Where large enterprises work across China, the domicile of the headquarters office shall determine the jurisdiction of the relevant provincial regulator's office. That office may of course liaise with offices in other provinces where the firm has business

There should be one budget for the Pension's Regulator with one central bank account operating on Single Treasury Account principles. Funds would flow directly from the Central Treasury. The Pension Regulator would submit the budget to the MOF after consultation with MOLSS. The Pension Regulator would be responsible for the allocation of staff and budgets to provincial offices and for approving virements of resources within central government finance rules. Overall the regulatory environment should be similar to those for the three existing commissions

Clearly a key question given the very low level of EAs is how to put in place a minimum structure and then scale up as EA development takes place. This is a more difficult question than that faced by any of the three existing regulatory commissions given that a basic market structure was already in place. Nevertheless the experience of the CIRC in particular may give some useful experience of how to expand structures and budgets in the light of a rapidly growing market

#### Question 4 How should the Pensions Regulator be financed?

The main three options for this are as follows:

- a) A purely tax based system (where taxes could also include social insurance)
- b) A purely fee based system based on contributions from sponsoring organisations and the Financial Services Industry
- c) A mixed economy of tax and fee based financing.

The main options for fee based financing in terms of payees and the basis of payment are given below

Rate	Flat Rate	Banded Flat Rate on employee numbers	% of Pension Fund Value in Plan / under Management
Fee Payer			
1) All Enterprises above minimum employment	Yes	Yes	No

number			
2) Enterprises offering annuities	Yes	Yes	Yes
3) Financial Services Providers	No	No	Yes
4) LSSBs for Urban IA	Yes per contributor	No	Yes
5) LSSBs for Rural IA	Yes per contributor	No	Yes

In considering any form of mixed economy financing system, due consideration needs to be given to the following

- i) The appropriate balance between Government subsidy and fee income
- ii) The costs (and difficulties) of administration, particularly if the collection of the fee is to be done by the Office of the Regulator
- iii) The incentives (positive and negative) any system of financing may provide in terms of setting up the EA.

The latter is particularly vital especially given the fact that the cost of social insurance for enterprises is high as a % of payroll (for complying organisations), and that any significant regulatory costs would be perceived as reducing the value of tax incentives. Given that EA development has only just started, this may be counter-productive. For financial services providers, they may feel that they are already bearing the regulatory cost levied by the financial regulatory commissions and this would be an unjustified burden.

It may be therefore appropriate to finance the Pension Regulator from the tax system. If it is considered desirable to introduce a fee based element, recognising the desirability of moving to a cost sharing arrangement in the future, the best solution may be to introduce a banded flat rate for all enterprises above 300 workers (the definition for large enterprises). Collectable with the annual business licence and payable to a central account preferably within the Central treasury system

#### Question 5 What sort of role should the Pension Regulator have?

The Office of the Regulator should have 9 principal roles as follows:

- i) To ensure that enterprises are fit to offer enterprise annuities and in particular that the company's economic position and corporate governance status is commensurate with providing a long term pension plan Because of the indirect benefit this may give in boosting corporate governance in China, consideration should be given to providing a mandatory tax rebate to any company undergoing and passing a corporate governance test irrespective of whether it proceeds to set up an EA

- ii) To approve the establishment of the EA plan including application of good corporate governance practice, appointment of trustees, recruitment and remuneration of fund managers, reporting to stakeholders etc
- iii) To supervise the operation of plans utilising a risk based approach, but in general encompassing at least an annual review for each EA
- iv) Approving procedures for terminating or transferring EAs including approving the actuarial calculation of surplus or deficits for DB funds and the funding of any deficit or allocation of any surplus
- v) Applying administrative sanctions (fines and personal sanctions) against both organisations and individuals for infringement of regulations and having the power to close schemes where suspected frauds and abuse has taken place. It is a matter of judgement whether there should be a limit on the nature of sanctions that the office of the regulator can apply before applying to a judicial court for further action. In any event, the temporary suspension of the operation of an Ea and freezing of assets should be the right of the Pension Regulator and all actions should be subject to judicial review
- vi) The issue of any rules and guidance on the operation of EAs. Where these rules affect the structure of EAs (for example tax treatment of schemes or the payment of trustees) these must be issued under the authority of MOLSS and the MOF. The Office of the Regulator should have the authority in its own right to issue regulations on operational matters (eg the qualification of trustees, corporate governance, statement of investment principles etc)
- vii) The provision of training to enterprises, trustees, investment managers and LLSB officials on relevant aspects of pension and investment management, corporate governance etc
- viii) The collection of statistics on EAs, and individual accounts (if included within the remit of the office)
- ix) The provision of policy advice on EA / IA development, regulation and supervision. In terms of certain defined areas, the Ministry should be under a mandatory responsibility to consult with the Regulator and publish his /her advice

LSSBs should be restricted to the role of promoting EAs and vetting enterprises compliance with existing social insurance requirements, including full payment of contributions

In general the Office of the Pension Regulator should not be used to arbitrate on claims concerning the calculation of individual pension entitlements. This should be dealt with by a separate organisation (In the UK, it is handled by the Pensions Ombudsman), leaving the Office of the Regulator free to deal with systemic issues. Cases which raise fundamental questions on the regulation of the system could be referred to the Regulator (in much the same way that legal cases which contain fundamental points of law are referred to high legal tribunals).