An Introduction on China's Senior Pension Mechanism

Author: Michael Qu
Attorney at Law, Shanghai Co-effort Law Firm

While China's aging population rapidly grows in recent years, combining with raising expanse for living, more and more people are concerning about their retirement fund—how they can support themselves on medical expenses and elderly care? In this article, the author is trying to illustrate two financial sources people may resort to while seeking for financial support for elderly care and medical expense, which are welfare-financed and commercial-financed pension.

Welfare-financed fund

There are three pillars of social insurance with regard to employee pension: basic endowment insurance, enterprise annuity (supplementary pension) and personal deposit insurance.

-- Basic endowment insurance is statutory as a preliminary pension scheme in China. It is made up of payment from the employing entities, individuals and government subsidies. The basic pension premium for retirees is made up of the coordinated pension and the pension in the personal account. It is determined based on factors such as the individual's cumulative premium payment period, the wage from which premium payment is made, the average wage of the local workers, the amount in the personal account and the average life expectancy of the urban population. Nowadays, after 7 consecutive years of adjustment, national monthly basic pension premium has reached to an average of RMB 1,531 for every retiree.

-- An enterprise annuity is a form of supplemental retirement savings program that is voluntary. China has introduced enterprise annuities from 2004, allows Chinese companies to set up retirement benefit plans for individuals. The Chinese enterprise annuity system is adopted in a mode of defined contribution plan (DC Plan), which refers to employers and employees on a regular basis in accordance with a certain percentage of premiums paid to the staff personal accounts, where employee pension level depends on the scales of capital accumulation and its investment earnings. While the design of such program is flexible, there are some restrictions such as maximums on employer and employee contributions. In practice, enterprise payment cannot exceed one twelfth of its payroll of last year; employee's payment cannot exceed one twelfth of his/her total wage of last year.

-- Personal deposit insurance is also voluntary for adoption. It is paid to individual account of employee according to his or her wage similar to the nature of deposit and monitored by social insurance institutions. Currently, some places have issued personal deposit insurance, but there is no national unified policy in this regard.

Commercial-financed fund

1. Annuities insurance. It is a long-term pension insurance participated by customers and insurance companies, and it is also a supplementary of endowment pension. Currently, most commercial products for annuities insurance are fixed annuities, i.e., people pay regularly for a sum of money and get retirement pension in exchange for a certain period of time.

2、Long term care insurance

Long term care (LTC) is custodial assistance or skilled medical attention that required by people who are unable to take care of themselves fully for an extended period of time. LTC is very expensive, even in China, compare to the amount of money received from social welfare. Therefore, an urge for introducing an insurance mechanism has for years been discussed in China.

Derived from US in 1970's, and then expanded to Europe and South Africa, LTC insurance has world-widely been adopted as compulsory social welfare insurance. However, in China, LTC insurance is at an infant stage. Due to the lack of experience of statistics and ability on product design and pricing, only few insurance companies such as Cathay Life Insurance and China Health Insurance are selling this type of product. Given the high cost of commercial insurance premium that makes it impossible for LTC insurance to have a full coverage within seniors, some experts suggest to placing LTC insurance as a part of social insurance, that can be paid together with endowment and medical insurance.

Meanwhile, a critical issue to be solved now in order to attract more people or employers to participate in commercial pension insurance, or even enterprise annuity, is to introduce individual income tax incentives. In November 2011, Shanghai and Beijing municipal government separately announced plans to roll out pilot scheme of individual income tax-deferred pension plan (IIT-deferred pension plan). As reported, six insurance companies including China Life, Pacific and Ping An are entitled to take part in the preparation phase of the pilot scheme. In essence, under the proposed IIT-deferred pension plan, qualified individuals will be eligible to claim IIT deduction for personal pension contributions with a monthly ceiling applied, and defer the IIT payment until receipt of the pension in retirement. IIT-deferred pension plan has become an international practice, such as the 401(k) plan and Individual Retirement Account (IRA) plan in the U.S. and Mandatory Provident Fund in Hong Kong that in order to encourage personal contributions to supplementary pension plans.

3、House-for-pension scheme or reverse mortgage

You may find in China, only a very few people are fortunate to have enough employee pension who will have a steady income to afford retirement life in private senior houses or facilities, and for most seniors, the situation is they have capital locked up in property with no steady income, so their only real option would have been to remortgage their flat or to sell it to raise capital. So, as a viable option, house-for-pension scheme or reverse mortgage program seems to be able to solve the problem. In a house-for-pension scheme, homeowners usually sell their homes, whether to service providers or buyers in the fair market, in the first place; while in a reverse mortgage the property is still held by homeowner until he or she passes away or chooses an early termination in some cases. Both are in exchange for a life-time stay in senior facilities or a sustained pension supply.

To be clarified, there is no officially legitimate practice in reverse mortgage, and house-for-pension schemes are only piloted in some cities, those who want to provide such a scheme can only make this happen by reach an agreement with the homeowners. In practice, we will advice participants to be careful about three issues: (a) providers to fully disclose the rights and obligations of the deal in order to make sure the deal is concluded through a fair and sufficient consultation; (b) Make sure of the fairness of a house-for-pension deal; and (c) if possible, being granted confirmation by the homeowner's children or couple.

In the past, we've seen some practice, whether in Shanghai or in Nanjing, mostly failed to succeed due to unbalance between profits and costumers' acceptance. And recently, China Citic Bank announced that it is going to provide a new type of reverse mortgage. According to the introduction, borrower, be senior or his legitimate successor, shall mortgage his apartment to the bank in order to obtain a loan to the senior that paid as monthly pension with a maximum term of 10 years. Among other qualifications for borrowers to apply for this financial product, one is the borrowers should own more than one apartment. Instead of being a typical reverse mortgage product, this is more like a loan service targeting to aged costumers. Without participation of insurance companies who can calculate risks by factoring in senior's age, average life expectancy, value of mortgage assets and pension amount, the bank is unable to take the risks of unexpected life expectancy and devalue of house—therefore the longest term is only 10 years and at the end of the day, borrower will have to find out how to pay back the loan or otherwise loss his property. We believe as a trial for banks to test the market of elderly service, it is an immature product but is better than nothing.

As a conclusion, we think both sources for senior's retirement fund as above discussed are insufficient for seniors and it is time for the government and financial companies to promote more pension programs to increase the premiums of aged people.

Michael Qu is a lawyer at the Shanghai Co-effort Law Firm—an international law practice with more than 200 lawyers in 8 offices in Shanghai, Beijing, Osaka (Japan), Suzhou, Changsha, Nantong, Xiamen, and Inner Mongolia. With more than a decade's experience in foreign investment, corporate and real estate law, Michael is now focusing on legal practice in the fields of senior housing and care, commercial real estate development, and retail and private equity investment. For more articles and insights, please refer to Michael's monthly Newsletter on China Senior Housing and Care, which can be subscribed to by sending a request to Michael's e-mail address: quqin@co-effort.com.