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Collective Pension Funds

INTERNATIONAL EVIDENCE AND IMPLICATIONS FOR CHINA'S ENTERPRISE ANNUITIES REFORM

Yu-Wei Hu, Colin Pugh, Fiona Stewart, Juan Yermo

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Financial Affairs Division, Directorate for Financial and Enterprise Affairs
Organisation for Economic Co-operation and Development
2 Rue André Pascal, Paris 75116, France
www.oecd.org/daf/fin/wp

ABSTRACT/RÉSUMÉ

COLLECTIVE PENSION FUNDS – INTERNATIONAL EVIDENCE AND IMPLICATIONS FOR CHINA'S ENTERPRISE ANNUITIES REFORM

Collective pension funds (CPFs) - occupational pension funds that cover the employees of more than one employer (enterprise) - have been operating in OECD countries for decades. Generally speaking, there are two models, i.e. closed pension funds, with membership restricted to a particular industry or group of industries, and open pension funds open to all types of company. The governance structure of such funds also operates in two ways – via an internal model (with trustees appointed by employers and employees) and external model (with professional, commercial trustees). In this report, we first describe and analyse how CPFs are operated in selected OECD countries and non-OECD economies. Then, we review occupational pensions (or Enterprise Annuities -EA- in Chinese terminology) in general and CPFs in particular. Given the problems holding back the development of EA plans among small and medium size enterprises (SMEs) in China, and bearing in mind both China's specific situations and international best practices, we propose a number of policy recommendations to promote the development of CPFs covering the SME sector. Our practical policy recommendations include 1) industry funds with more open membership; 2) establishment of new purpose-built industry funds; 3) establishment of new regional EA administration centres acting as independent pension councils (trustees) for open pension funds; 4) in parallel to these policy initiatives in China, commercial trustees should be encouraged to establish CPFs targeting the SME sector.

JEL codes: JEL: G23, P52

Keywords: Pension funds; collective pension funds; enterprise annuities; small and medium size enterprises (SMEs); industry funds; master trusts, China.

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ABSTRACT/RÉSUMÉ

FONDS DE PENSION COLLECTIFS – OBSERVATIONS INTERNATIONALES ET CONSÉQUENCES POUR LA RÉFORME DES RENTES D'ENTREPRISE EN CHINE

Les fonds de pension collectifs (FPC) – fonds de pension professionnels qui couvrent des salariés relevant de plusieurs employeurs (entreprises) – existent dans les pays de l'OCDE depuis plusieurs décennies. De manière générale, il existe deux modèles : des fonds de pension fermés auxquels seuls peuvent adhérer les travailleurs d'une certaine industrie ou d'un groupe d'industries, et des fonds de pension ouverts auxquels peuvent adhérer les travailleurs de toutes entreprises. De même, il y a deux modèles de structure de gouvernance : un modèle interne (où les fiduciaires sont désignés par les employeurs et les travailleurs) et un modèle externe (où les fiduciaires sont des professionnels qui agissent à titre commercial). Dans ce rapport, nous commençons par décrire et analyser la façon dont les FPC sont gérés, dans certains pays de l'OCDE et dans certaines économies extérieures à la zone de l'OCDE. Puis nous examinons la question des pensions professionnelles (en Chine, on parle de rentes d'entreprise), de façon générale, et des FPC en particulier. Étant donné les problèmes qui freinent le développement des systèmes de rentes d'entreprise dans les petites et moyennes entreprises (PME) en Chine, et compte tenu, par ailleurs, des spécificités de la situation chinoise et des pratiques optimales définies au niveau international, nous formulons un certain nombre de recommandations pour promouvoir le développement des FPC dans le secteur des PME. Nos recommandations, concrètement, sont les suivantes: 1) ouvrir plus largement l'adhésion aux fonds par industrie; 2) créer de nouveaux fonds par industrie spécialisés; 3) mettre en place de nouveaux centres régionaux de gestion des rentes d'entreprise qui joueraient le rôle de conseils indépendants (fiduciaires) pour les fonds de pension ouverts; 4) parallèlement à ces initiatives d'ordre public, en Chine, des fiduciaires agissant à titre commercial devraient être encouragées à créer des FPC ciblés sur le secteur des PME.

Codes JEL: G23, P52

Mots clefs: fonds de pension; fonds de pension collectifs; rentes d'entreprise; petites et moyennes entreprises (PME); fonds par industrie; fonds maîtres; Chine.

COLLECTIVE PENSION FUNDS – INTERNATIONAL EVIDENCE AND IMPLICATIONS FOR CHINA'S ENTERPRISE ANNUITIES REFORM

Yu-Wei Hu, Colin Pugh, Fiona Stewart and Juan Yermo[1]

1 Introduction

Collective pension funds (CPFs) are independent entities containing the pool of assets acquired for the exclusive purpose of financing pension plan benefits of employees which are not from the same company or holding group of companies. In other words, CPFs are different from single company (or group) pension funds, which cover only the employees of a specific enterprise (or group of companies under the same ownership). CPFs have been operating in OECD countries for decades, although the specific forms vary from country to country.

It is worth noting at the outset, and also for the reason of completeness, that besides the above-mentioned pension fund structure, another form of occupational pension arrangement is also common in some OECD countries, i.e. pension insurance contracts. A pension insurance contract is defined as an insurance contract that specifies pension plan contributions to an insurance undertaking in exchange for which the pension plan benefits will be paid when the members reach a specified retirement age or on earlier exit of members from the plan[2]. Such arrangements, however, are not discussed in this report.

It should also be noted that we will discuss collective pension funds available via employment arrangements, while personal "retail" funds offered directly to individuals with no involvement of their company or employer are not covered in this report. Finally, the "collectivity" discussed in this report is what is known in China as "front-end collectivity", whereby different company sponsors pool their contributions in a common pension fund under the responsibility of a single board of trustees or corporate trustee company, which then selects asset managers and other service providers if deemed necessary. Back-end (asset management) collectivity means each single employer sets up its own pension fund with typically a fund-specific trustee board (pension council model) and buys standardised "collective pension products" from financial institutions (e.g. asset managers).

In China, the majority of enterprise annuities (EA) plans (the term used for occupational pension plans) are sponsored by the large and profitable state-owned enterprises (SOEs), while SMEs find

[1] The authors would like to thank delegates to the OECD Working Party on Private Pensions for useful comments and participants in the OECD/MOLSS Meetings on 15-16 May 2007 in Beijing for constructive discussions, especially Stephen Glenfield from APRA, Australia and Hendena Yu from MPFA, Hong Kong, China. The views expressed herein are those of the authors and do not necessarily reflect those of the OECD or the governments of its Member countries. The authors are solely responsible for any errors.
Correspondence author: Yu-Wei Hu, Private Pensions Unit, Financial Affairs Division, Directorate for Financial and Enterprise Affairs, Organisation for Economic Co-operation and Development, 2, rue André Pascal, Paris, F-75775, France. E-mail: yu-wei.hu@oecd.org.
[2] OECD Classification and Glossary on Private Pensions (2005).

such plans either too expensive or administratively complicated. Recent statistics show that as of February 2006, only 1% of the EA assets were accumulated by SMEs in China. This EA "vacuum" among SMEs is not only inconsistent with the current central government's ultimate goal of establishing a "harmonious society", but also holds back further development of the EA market. Given these concerns, the Chinese authorities (notably the Ministry of Labour and Social Security MOLSS) have been considering how to encourage SMEs to join EA plans via CPFs.

In this paper, we will first describe and analyse how CPFs are operated in selected OECD countries and non-OECD member economies. The examples will not be exhaustive, as the primary objective is to develop a solution[3] that is appropriate for China. Then, we review China's EA market in general and CPFs in particular, highlighting the problems holding back development of EA plans among SMEs in China. Given the specific Chinese context and bearing in mind international practices, we will propose a number of practical policy recommendations on how to promote and develop EA plans among SMEs in China via properly designed CPFs. Last, we will include four annexes, covering four examples (i.e. Australia, Hong Kong, China, the Netherlands, and the United States) promoting further detail about CPF arrangements in the respective economies.

2 Summary of CPFs in OECD countries and Hong Kong, China

As given in Table 1, there are two main forms of CPFs – industry funds and master trusts, which can be classified along two main dimensions: membership and governance. Closed pension funds' membership is restricted to specific industries, while members of open funds can come from any company. The governance structure of collective pension funds also operates in two ways – via an internal model (i.e. pension council in Chinese terminology), with trustees appointed by employers and employees, and an external model (i.e. corporate trustee in Chinese terminology), with financial institutions acting as professional, commercial trustees. One example for the former is the industry funds which are dominant in the Netherlands and Denmark, while examples of the latter include master trusts in OECD countries (i.e. Australia and the United States), and the master trust schemes in Hong Kong, China.

Table 1 Classification of CPF in selected OECD countries and Hong Kong, China

	Open membership	**Closed membership**
Internal model	1. Open industry fund (Australia) 2. Collective pension foundations (Switzerland)	1. Traditional industry fund (Australia, Denmark, Netherlands) 2. Multi-employer (Taft Hartley) funds (United States)
External model	1. MPFs – master trust (Hong Kong, China) 2. Master trusts (Australia, United States)	MPF - industry fund (Hong Kong, China)

Source: OECD.

[3] As noted above, in OECD countries occupational pension plans are mainly financed by two alternative vehicles, pension funds (set up as trust in countries with an Anglo-Saxon tradition, as well as in China) and pension insurance contracts. In this report, we will mainly focus on the former. Meanwhile, as in China, pension insurance contracts in some OECD countries (e.g. Italy and Spain) are not subject to the same (more favourable) tax treatment as pension funds in other countries (e.g. the Netherlands and the United States).

Industry funds in OECD countries have largely arisen from negotiation between trade unions and employers, so that the collective bargaining mechanism has generally been the foundation for setting up such funds. For example, Australian trade unions were actively involved in the design and development of the first industry funds in the early 1980s (in conjunction with the economic objective of containing inflationary pressures by directing a part of wage increases to long term retirement savings). Meanwhile, for the industry funds in the Netherlands and other countries (e.g. the United States), the strong collective bargaining mechanism between employees and employers or their representatives has played an important role. Although industry funds have been established in many different industries, it is observed that they are particularly popular among two types of industry. Firstly, in traditional, manufacturing industries, such as mining, steel or auto manufacturing. Secondly, in industries with "mobile employees", i.e. those who do not stay with the same employer for a long period of time, for example, those working in the construction, hospitality, textile, and catering industries. Furthermore, although industry funds have been traditionally restricted to the members belonging to certain industries, their membership was recently extended to the general public (including SMEs) in Australia.

The key advantage of the industry funds in more mobile industries has been cost efficiency for the SMEs, largely due to economies of scale achieved by pooling pension assets together from different businesses. SMEs would otherwise be unlikely to be able to afford setting up their own pension plans. A second key advantage is the embedded portability for the plan members, since they do not need to switch pension funds when they change jobs, as long as the two employers concerned participate in the same industry fund. Another advantage of industry funds is the strong focus on the protection of beneficiaries' interests, often achieved through the equal representation of employee and employer groups at the trustee level, without the inherent conflict between commercial interests and fiduciary duties.

Another main form of CPFs are master trusts, in which standardised investment products are designed by financial institutions or corporate trustees and offered to any company (open membership). The key difference here is that the trustees intend (in return for capital, entrepreneurial, human resource and technology support) to make a profit by selling their pension products to companies. This form of CPFs is common in OECD countries and has also become a key component of the overall social security system in many non-OECD economies. For example in Hong Kong, China, the master trust scheme is the typical type of master trust and accounts for 36 out of 40 mandatory provident schemes. In the United States, financial institutions have designed a range of collective investment products (e.g. simplified employee pension plans SEPs), aiming to attract employers in the SME sector.

The main merit of master trusts is that they are generally simple for employers (specially SMEs) to join and operate. Meanwhile, the services provided by financial institutions are another advantage, largely due to the fact that trustees are professionals with expertise in investment and finance, and with experience in administering and managing pension funds. However, despite the above strengths, master trusts might be disadvantaged due to the inherent conflict between fiduciary duties and operating on a commercial basis, with employees and employers not normally represented on the board of trustees.

2.1 Industry fund

For this form of CPFs, different terms have appeared interchangeably in the literature; they are multi-employer funds, industry funds or industry-wide funds. In this report, we do not distinguish them unless specified otherwise.

2.1.1 Characteristics

The typical form of industry funds covers employees of enterprises that do not have common ownership but that operate in the same industry. A frequently observed variant is that unionised employees (possibly from different industries) participate in the same multi-employer schemes. In both cases, trade unions and industry associations play an important role in setting up and administering the schemes. Representatives of both employees and employers sit on the board of trustees and jointly make decisions about the running of the schemes, although they often hire professional managers to conduct daily activities relating to the funds. In this context, equal representation for employee and employer representatives is almost always observed, although some plans are administered entirely by the unions. In addition, outsourcing activities are common, in which investment, custody and other services, etc are outsourced and conducted by external professional service providers.

2.1.2 Introduction and evolution

Industry funds are important players in the pension fund markets of OECD countries. For example, in Australia as of September 2006 there were 82 industry funds and the total amount of assets under management was AUS$ 162 billion (i.e. 17.2% of the whole superannuation market). In the Netherlands, industry funds are a popular pension arrangement as well, with over 80% of the work-force who participate in the occupational pensions market covered by such funds. As of 2006, there were more than 70 industry-wide pension funds in the Netherlands. Industry-wide pension plans also dominate the occupational pension scene in Denmark. In addition, industry funds also exist in other economies although on a smaller scale in terms of participation, coverage and pension fund assets. For example, in the US multi-employer pension schemes have been popular in such industries where workers typically do not stay very long with the same employer, e.g. light manufacturing industries (e.g. food and confectionery, printing and publishing, and furniture), construction, transportation (trucking) and other non-manufacturing industries (e.g. wholesale and retail trades). Meanwhile, in Hong Kong, China, two industry funds are currently in operation; one is for the construction industry, and the other is for the catering industry, while in Germany, industry funds were established in several industries, e.g. chemical and metalworking industries.

It has been argued that industry funds have their historical roots in the communication and collective bargaining mechanism between trade unions and industry associations of employers, which enable the establishment of industry funds on a collective basis. In Australia, industry funds started to grow fast from the late 1980s onwards, and during this period, unions played an important role.

In the Netherlands, the story is similar in that the formal negotiation mechanism between employees and employers or their representatives has been in place for a long period of time. In this context, employee unions and employer associations are frequently engaged in communication and dialogue in addressing the issues in which both parties are interested, (including pension arrangements). Like Australia, this arrangement in the Netherlands has to a large extent facilitated the establishment of industry funds, especially given the collective bargaining mechanisms already in place.

Membership of industry funds has been traditionally limited to specific industries. However, this has changed over time. For example, in the Australian superannuation system, many industry funds have started to open membership to workers in companies outside their industry, mainly for the reasons of retaining existing members who leave the industry for which the fund caters, expanding membership generally and achieving greater economies of scale. In the Netherlands, however, the general rule regarding restricted membership still dominates.

In Switzerland, insurance companies offer “collective foundations” for SMEs and other enterprises that want to avoid the complications of establishing and maintaining their own pension foundations. In this case, the “collective foundation”, established by insurance companies, is run by professional directors typically appointed by the same insurance companies or their parent companies, with no representation from employees and employers. This collective foundation then purchases insurance from the parent insurance company and outsources other services to professional institutions (e.g. asset investment) if deemed necessary.

Industry-wide pension plans also exist in other OECD countries, e.g. Canada and Germany, countries where trade unions have been traditionally common. For example, in September 2001, the Mining, Chemical and Energy Union (IG BCE) and the German Federation of Chemical Employees’ Associations (BAVC) made an agreement to establish an industry-wide pension fund, which is administered by a private bank but controlled by BAVC and IG BCE.

Furthermore, nationalisation of pension arrangements could go beyond the industry level. For example, in Sweden most salaried employees are covered by the ITP scheme which is a nation-wide scheme based on collective agreements between the Swedish Employer’ Confederation and the trade unions for salaried employees within the private sector.

2.1.3 Regulatory framework

As noted earlier, industry funds are a product of collective bargaining between employees and employers or their respective representatives. Against this background, the trustee board in Australia and the United States (and the governing body of the foundation for the Netherlands) typically has equal numbers of representatives from both sides. In this case, the employee representatives should be appointed or elected by the plan members and beneficiaries or organisations representing their interests, and they are not necessarily the members of the fund (for example, they could be the professional individual trustees representing employees). Employer representatives should be appointed or elected by the participating employers or the employer association(s) involved in the collective bargaining. In Canada, multi-employer plans are jointly administered by the union and the employers' federation (at least 50% employee representation), but they can be also run solely by the union itself.

Based on the current pension regulation laws in Australia, employers must contribute to a fund on behalf of their employees. Prior to 1 July 2005, the fund was usually mandated in an industry award or agreement, however since that date employees are generally free to choose the fund into which their compulsory contributions are paid. Although it is not compulsory in the Netherlands, employers can send a request to the government asking permission to set up a mandatory industry fund, if these employers represent the interests of 60% of the whole work-force in the industry.

In order to ensure appropriate representation of all members within the fund, the existing regulation in Australia does not allow any unnecessary restriction which prohibits certain groups of members from being nominated. However, it is acceptable to set a quota for member representatives from specific geographical locations, in order to protect interests of those members from under-represented or smaller regions. In this context, an interesting observation in the Netherlands is that joint chairpersons exist, one representing employees, while the other representing employers, with the two chairs rotating responsibility to chair the board on a yearly basis. This rotation is important because in the event of a tied vote the chairperson has an additional casting vote.

In some OECD countries, an individual independent trustee may be appointed to the board of trustee, partly to balance the interests of employee and employer representatives or to provide additional expertise. Such an appointment may occur if the pension regulatory or supervisory body holds the view that the board is not acting sufficiently to protect beneficiaries' interests. In some cases, the independent trustees may serve as the chairperson, and interestingly in Australia it is stipulated that the independent trustee or independent director of the board possesses a deliberative vote rather than casting vote - this restriction supporting the principle that employee and employer representatives should be the ultimate decision makers of the industry funds.

Trustees of industry funds in Australia and the Netherlands (who are typically senior managers/officials of the respective trade unions and industry associations) are normally voluntary and traditionally unpaid. This is because, 1) they work on a part time basis, their time as trustees effectively being limited by their main job, and 2) it is argued that the unpaid role of trustees ensures the trustees work solely for the interests of beneficiaries, rather than any commercial interest. However, it is becoming common for trustees of industry funds in Australia to be remunerated, but only for the time they spend on fund-related issues.

Given that many employee and employer representatives are not professionals in areas such as investment or actuarial issues, an advisory board is sometimes established alongside the main trustee board, such as is the case in the Netherlands. In this case, representation of employees and employers is frequently required, although it is not necessarily on an equal basis.

In the United States, collectively bargained retirement plans involving more than one employer are required to have a joint board of trustees, half elected by the union and half by employers. These plans are often defined benefit plans covering union members in a region and type of job (such as trucking, mining, or broadly service related).

Some countries also require trustee to purchase indemnity insurance. In Australia, for example, trustees must purchase appropriate insurance (offered by insurance companies) against any liability to which they may be exposed when they conduct their fiduciary duties. However, cover is not available in cases where losses are due to the trustee's dishonesty, deliberately failing to exercise the required degree of care, or incurring a monetary penalty under a civil penalty order.

2.1.4 Key merits and weaknesses

The biggest advantage relating to industry or multi-employer funds is that these are non-profit bodies and therefore the potential problem of conflicts of interests between shareholders and beneficiaries does not normally arise. The interests of beneficiaries are thought to be better protected, largely due to the full involvement of employees and employers or their respective representatives in running the funds. Another key merit relates to economies of scale, given that most industry funds countries such as Australia and the Netherlands are large in comparison to smaller individual company funds. Consequently, this should lead to lower transaction costs, particularly in contrast to master trusts. In the same context, it is also easier for larger funds to afford high quality service providers.

Meanwhile, another clear advantage of multi-employer funds is the ease of portability for the plan members. When they move from one employer to another employer that is also participating in the same multi-employer plan, their pension plan participation and pension accruals are continuous. There is no need to terminate membership and then rejoin that plan or a new plan.

While equal representation has the benefit of allowing employees and employers greater control over their pension funds, it also has drawbacks. Largely due to lack of expertise of trustees, their decisions (especially those related to the investment of the pension fund assets) might not be optimal. This issue is usually addressed by hiring external consultants or providing training to trustees, with the additional costs involved hopefully offset by higher net returns.

2.2 Master trust

In addition to industry funds, another form of CPFs which is common in developed economies, including OECD countries and Hong Kong, China, is the standardised master trust, which by definition is open to all corporate plan sponsors. This arrangement is popular largely due to easy joining and operation on the plan sponsor's part, and heavy promotion by the financial sector for commercial reasons.

2.2.1 Characteristics

The typical type of master trust is a standardised investment product offered by financial institutions in the pensions market. In this case, any interested plan sponsor (which is not necessarily to be in the same industry as the above-mentioned industry funds) can establish/purchase such funds, subject to agreement on fees and investment strategies, etc. Selection of service providers and/or the financial products are in general decided by employers (rather than employees). In many cases, a range of investment products with different risk-return profiles are available, which are then targeted at plan sponsors or groups of participants with different risk preferences.

In comparison with industry funds, the trustees of master trusts are nearly always profit-oriented[4], i.e. they operate for commercial reasons, providing professional services - although by law they still have the fiduciary duty to act in the interests of the members and beneficiaries of the pension plan. In terms of organisation, master trusts often operate on a "one-stop shopping" basis, where different professional services, e.g. asset management and record keeping, are bundled vertically and managed *de facto* by the same financial institution or group. In other words, the various service providers are likely to be separate (legal) entities, but they are often part of a larger (parent) financial institution.

2.2.2 Introduction and evolution

The development of master trusts has been closely linked to the overall development of financial markets, particularly the fund management industry, given similarities in terms of investment products, requirements for specific expertise etc. Not surprisingly, some OECD countries, e.g. Australia and the United States, are home not only to a developed retail pension fund industry, but also to mature financial markets in general.

As of September 2006, the total assets within the superannuation (pension) system in Australia were AUS$ 946 billion. Among the different types of schemes, however, master trusts represent the largest share, i.e. 32.4% with assets at AUS$ 306 billion in 2006. Hong Kong, China also has a developed master trust industry, as master trust schemes remain the most popular form of pension arrangement. For example, as of March 2007, out of 40 existing pension schemes in Hong Kong, China, 36 were master trust schemes, while two were industry schemes, and another two were employer-sponsored schemes.

In addition to the trust-based CPFs, other forms exist in some OECD countries. For example, in Portugal, pension funds are not operated as a trust, but as independent organisations without legal personality. In this case, they are managed by professional pension fund management companies (limited liability companies created solely for the business of managing pension funds).

In terms of providing pension services, it can be argued that financial institutions react quickly in order to better respond to market demands. For example, in the United States, traditional occupational pension schemes have also been difficult for SMEs to set up or join, given regulatory complexity and high costs. Consequently, the financial markets as well as the pension regulatory authorities have worked together and designed a range of collective products which are available for SMEs on an affordable and effective basis. Clear examples include the simplified employee pension plans (SEPs) and SIMPLE IRA plan, among others, in the United States.

[4] Exceptions include the mutual pension insurance companies that operate in many European countries.

2.2.3 Regulatory framework

Trustees of master trusts are subject to stricter regulations than those in the industry funds, mainly given the concerns which arise from the fact that they are operated on a commercial basis. Regarding capital requirements, for example, in Hong Kong, China, the MPF legislation stipulates that a trustee company should have a paid-up share capital and net assets of at least HK$ 150 million, while in Australia, there is a similar requirement on the licensed retail trustee, consisting of AUS$ 5 million (also applicable to industry funds which open their membership). The main purposes of having a prescribed capital requirement include to provide some financial resources to act as a buffer against any potential risks and to ensure the financial soundness of the trustees among others. In addition, in Hong Kong, China 0.03% of assets are deducted from the scheme assets (in the form of compensation fund levy) as an extra layer of protection on the interests of beneficiaries (e.g. covering losses due to misfeasance and illegal conduct committed by MPF trustees).

Where master trusts operate under a trust system, representation of employees and employers (equal or otherwise) on the board of trustees is generally not required. Normally, directors of the board of trustees are appointed by the financial institutions who offer the retail pension fund, and they often have professional experience and expertise in running pension funds. Meanwhile, they may be paid as the general directors if they work on a full-time basis.

Pension fund regulatory and supervisory authorities use various methods to try and ensure that commercial trustees fulfil their fiduciary duties properly. For example, in Hong Kong, China, the trustee board should have at least one independent director who in turn needs to meet certain criteria (e.g. not be a director of an associate of the trust company, not hold any share of the trust company, etc). There is no specific requirement in Australia although trustees must meet fitness and propriety standards. However, the Australian legislation prescribes that the commercial trust company should set up at least one policy committee with representatives of employers and employees. In this case, the policy committee mainly serves in the same way as an advisory board and does not have voting power.

In addition to requirements for independent directors and oversight bodies, such as policy committees, trustees in Hong Kong, China and Australia should have adequate insurance to cover the potential losses due to the maladministration of the scheme by the trustees. Such indemnity insurance (offered by insurance companies) should cover a specified amount/percentage of the total assets under management in Hong Kong, China.

Given that financial markets are risky, one way in which regulatory authorities, (such as those overseeing the mandatory pension fund system in Hong Kong, China), offer some protection to members of retail pension funds is to require that one investment option offered to members has to be a capital preservation fund which typically invests in low risk money market products. Master trusts in many other countries are not subject to equivalent regulations as in Hong Kong, China, and they simply follow the principle of prudential investment to reduce and diversify risks.

2.2.4 Key merits and weaknesses

The major merit of master trusts is that all pension-related services are provided by financial institutions, as plan sponsors need only "shop" around the market, choose a suitable pension fund provider and remit contributions to the provider once they have made their choice. This is particularly relevant for unrelated SMEs, given the difficulty, if forced to jointly choose a provider, of reaching a consensus among diverse SMEs members which differ in terms of size, business scope, industry etc. Another advantage relates to the quality of service and professional expertise provided by financial institutions, given their experience in administering and running pension funds.

However, poor representation of employees and employers on the trustee board is one of the main weaknesses for master trusts, and the question as to how to align trustees' commercial interests and their fiduciary duties is difficult to answer. Concerns relate both to actual/potential conflicts-of-interest and general loss of control by the plan sponsors (employers). A related point is whether the high fees charged by master trusts in comparison to industry funds are justified by better fee-adjusted returns in the long run. The advantages of one-stop shopping are clear, but a directly related concern is that the services are "bundled" and thus the pricing structures are rarely transparent. This bundling and limited flexibility can become aggravated when the employer grows from being an SME (in need of such retail-type products) to a large employer that could otherwise stand alone and operate a single employer fund (with all its flexibility and control and clear differentiation of functions).

3. Review of the EA and CPFs in China

3.1 A brief review on China's EA and CPFs

3.1.1 EA markets in China

The concept of occupational pensions (referred to as Enterprise Annuities – EA - in China) was first introduced to the Chinese pension system in late 1990 when the Chinese authorities started to implement the multi-pillar model recommended by the World Bank. After over 10 years of development, many enterprises across the country have established complementary pension plans on a voluntary basis. Most of these funds were set up before the Enterprise Annuity legislation of 2004 was passed. Such funds are generally known as "legacy EAs". Some, new EAs have also been established under the new 2004 legislation. Currently, the "legacy EA" market in China comprises four players, namely:

a) The EA Administration Centres, which were purposely established to administer and manage pension funds accumulated in a particular region. The most notable two are the Shanghai EA Administration Centre and Shenzhen Administration Centre. These EA Administration Centres, are *de facto* part of the local social security bureaus. As of 2006, the Shanghai EA Administration Centre accumulated over RMB 10 billion of pension assets, while it was RMB 2.3 billion for the Shenzhen Administration Centre.

b) In many other regions, such EA assets were simply handed over to the local social security bureaus which then deposited these assets in banks and/or bought government bonds (note in this case, there is no establishment and involvement of the EA Administration Centres). The total amount of assets under control of the local social security bureaus (both (a) and (b)) was estimated to be around RMB 15 billion as of 2005.

c) Industry funds (e.g. power and electricity) were established voluntarily and managed internally by the respective industries themselves. Similar to a), the relevant industries normally established their own EA administration centre or department, and such funds are consequently managed centrally within the industry. As of 2004, EA funds within this category were estimated to be RMB 35 billion[5], among which the State Electricity EA Centre controlled more than RMB 10 billion of assets.

d) In order to provide pension products for their employees, many other profitable "stand-alone" companies, directly bought insurance products from insurance companies. In this regard, contributions from employers used to buy insurance products are not viewed as EA funds according to the current legislation and are therefore not entitled to the tax relief benefit. As of 2005, it was estimated that around RMB 43 billion assets were accumulated under this category.

In total, the EA schemes – currently primarily established by profitable enterprises/industries in China – have accumulated RMB 91 billion assets[6] as of 2006 (75 billion of which are 'legacy funds' held by EAs established before the 2004 pension legislation). Based on estimates by Stirling Finance, Hong Kong, China[7], the overall (legacy and new) EA assets in China could grow to the level of RMB 700bn by 2015, although more optimistic estimates see RMB 700bn five years earlier, i.e. by 2010, as indicated in the same report.

Although the EA market has witnessed sizable growth in the past, this market was less regulated, given the fact that its driving force was largely from profitable, large enterprises and the private sector. The main legislative efforts of the Chinese authorities had been focused on the establishment and strengthening of the social security system[8], as seen from the release of a number of major regulations on these issues and heavy fiscal transfer from the central government to the local governments to help fund social security schemes. Recently, however, the Chinese authorities have again begun to focus on the concept of occupational pensions and have started to promote their development in a more systematic matter. In this regard, a number of reform initiatives and regulations have been directly linked to the EA plan, for example, the *Decree No. 20 Interim Measure for Enterprise Annuities Schemes*, and *Decree No. 23 Interim Measures for Management of Enterprise Annuities Fund* (hereinafter Decrees 20 and 23) were issued by the Ministry of Labour and Social Security in 2004.

[5]SINA (2005). http://finance.sina.com.cn/stock/y/20050330/14281473729.shtml; accessed on 20 February 2007.

[6] http://www.cnpension.net/Article_Show.asp?ArticleID=21819; accessed on 4 April 2007.

[7] CLSA (2006). "Moving on up: pension funds in Asian markets"; Hong Kong.

[8] The mandatory public pension part of the multi-pillar model in China comprises two components, i.e. pillar 1A and pillar 1B. Pillar 1A provides defined benefits and operates on a PAYG basis, with contributions at 20% of payroll and wholly from enterprises; the target replacement rate is 35% of the final-year salary. Pillar 1B should in theory be fully funded with sole contributions of 8% of salaries from employees; the target replacement rate is 24.2%.

According to these two regulations, new EA funds in China should be managed based on the trustee model, which can be either an external trustee (professional corporate entity) or an internal trustee (pension council). Existing corporate pension plans – i.e. 'legacy EAs' - are still allowed to exits, though they are not subject to favourable tax treatment. Furthermore, it has been noted that these legacy funds will have to comply with the new EA legislation in the future. However, it is apparent that the concept of trust law is neither really understood nor implemented appropriately in China. For example, under the external trustee model, in practice employers (rather than trustees) directly select and appoint EA service providers (e.g. asset managers and custodians). Under the internal trustee model, it is also usually the employer who plays a critical role in the selection process of service providers, as the internal trustee board in most cases is *de facto* controlled by the plan sponsor.

Concerning the new EA funds (i.e. those based on Decrees 20 and 23), statistics show that as of June 2006, 263 enterprises (mostly large profitable companies) in China had established such (single company) occupational pension plans. The corresponding number of participants was 940,000 and total assets amounted to RMB 11bn. It is noted that before 2004, a large amount of EA assets were managed by the local EA Administration Centres (part of the labour bureaus, and whose main responsibility is to manage assets in pillars 1A and 1B). However, due to pension investment scandals across the country (particularly that in Shanghai in 2006), the Chinese central government has recently shown their willingness to transfer all those EA funds (i.e. currently managed by the local social security bureaus) to the private sector by 2007. In this context, on 26 April 2007, one guideline from MOLSS was released, detailing how such legacy funds should be transferred. The key message is that all assets (i.e. from a to d above) should be handed over to the qualified institutions which implicitly refer to licensed financial institutions.

Of all new EAs, one noticeable case is the recent establishment of a nation wide pension fund by the Lenovo group, the world's 3rd largest personal computer marker. By outsourcing all services - i.e. trusteeship, administration, asset management and custody - to professional institutions, Lenovo's occupational plan started in July 2006 and became the first plan to be registered with the MOLSS office in Beijing[9]. The initial outlay was RMB 50m (US$ 6.3m) which will rise by RMB 20m in a year's time. In recent years, pension funds have also been established by many other company groups, although compared to the traditional industry funds discussed in the preceding section, they are small in terms of both membership and asset managed. However, they have the advantage of operating according to the new pension legislation.

A pending policy question is whether pension insurance contracts will be recognised under EA legislation and offered similar tax relief as pension funds. Life insurance companies in China have traditionally played an important role in China's occupational pension system. Their existence and rapid growth reflects the specific conditions during the period (starting from 1990s) when the central government allowed the development of occupational pensions by releasing general guidelines while leaving the details of implementation to the discretion of individual companies, industries, etc. Against this background, life insurance companies stepped in and secured a large share of the pensions market, given their expertise and experience in managing contractual

[9] It is noted that only cross-province/national new EA schemes need to report and register with the MOLSS in Beijing. For all the others, i.e. those established within a city/province, they only need to report to local branches of the MOLSS.

savings and their wide networks across the country. However, based on the new laws, the assets currently managed by the insurance companies are not viewed as EA assets and therefore are not entitled to tax benefits[10]. Currently, the insurance regulator in China (i.e. China Insurance Regulatory Commission CIRC) has requested the central government to reconsider its existing laws, and to treat the assets under control of the insurance companies as legitimate EA assets.

3.1.2 CPFs in China

As noted above, certain collective pension arrangements already exist in China. For example the local EA Administration Centres in different localities in China effectively operate collective pension funds. The existing industry funds managing legacy EAs are the other main form of CPFs in the country.

a) CPFs through local social security EA Administration Centres

The Administration Centres in Shanghai and Shenzhen were the largest such arrangements in China. Beside these, similar centres have also been created in other parts of the country, e.g. in Liaoning Province. Participating firms whose EA assets are managed by these local government centres are not necessarily linked by common ownership, or in the same industry. However, the majority of these participating firms are indeed profitable enterprises. The establishment of such centres is a typical example of intervention of the Chinese authorities to facilitate the development of chosen industries. However, based on the central government's plan to externalise the EA assets currently under control by local governments, the EA Administration Centres in China have been in the process of transformation. In principle, different options have been identified as possible solutions:

a1) The EA Admin Centres terminate administering and managing EA assets by a date specified by the central government, and all assets currently under management are returned back to the participating firms; then the firms themselves choose licensed trustees and other qualified service providers;

a2) Similar to the above, but the participating firms set up their own internal trustee boards, which then select qualified service providers;

a3) All businesses of the EA Admin Centres are transferred to one or more licensed trustees;

a4) The local EA Admin Centres are restructured from being *de facto* local governmental agencies to independent commercial trustees (i.e. collective pension trustees in a particular region).

It is noted that recently (i.e. January 2007) the Shenzhen Admin Centre adopted the a3) approach. In this regard, all the EA assets were transferred to China Merchants Bank (as custodian and account administrator), and Pingan Life (as trustee and asset manager). The transfer involved 250 participating firms with assets at RMB 2.3 billion. Although participating firms are allowed to

[10] Employer contributions of up to 4% of payroll to a qualified EA are a tax-deductible business expense. On the other hand, life insurance companies (subject to approval from the State Taxation Administration) are entitled to be exempted from the business tax (approximately 5%), but not the corporate tax (approximately 33%) in China.

change their own service providers, it is expected that majority of them will not do so as there is currently little differentiation between such service providers in China (and the transfer agreement specifies that they should choose the new service providers within three months of transfer). Meanwhile, regarding the Shanghai Admin Centre, the option a4) has been adopted. Specifically, a new insurance company named as “Yangtze River Pension Trust” has been recently established in Shanghai and also received a license from CIRC. Some sources note that the newly established company (which is currently in the process of applying for license from the MOLSS) will be responsible for administrating and managing the legacy pension assets, while for the new EA assets, any qualified service provider could compete on a free-market basis.

b) CPFs covering profitable industries

Currently EA plans have been established in 11 key industries in China, e.g. electricity, railway, and petroleum[11]. It is reported the assets are normally used to buy government bonds and invest in key state projects (e.g. Three Gorges Project), as well as group insurance products. In this regard, for some industries, e.g. electricity, the EA Admin Centre (de facto trustee) was established to administer the assets, while for others, the assets were simply managed by the finance departments at the headquarters in Beijing or regional headquarters across the country. In some cases, such finance departments are independent finance companies. It is thought that the assets of these existing industry funds are not managed in line with the Decrees 20 and No 23 regulations (i.e. the new EA legislation). However, it remains unclear how to transform such assets into the new EA regime, although some reform initiatives have been under discussion, and it is reported that such industries prefer to restructure their existing fund administration mechanism (e.g. by setting up internal trustee boards) in order to maintain control of the EA money.

3.1.3 “One-stop shopping” arrangements

“One-stop shopping” involves the vertical integration of various functions related to the operation of the pension fund within a *single* entity, which is common for CPFs in many OECD countries. Setting aside consulting, auditing and other clearly external services, Chinese legislation has already identified the four fundamental layers in the creation and operation of a pension fund, namely:

a. Trust management, through either a pension council or a corporate trustee entity.
b. Investment management.
c. Record-keeping.
d. Custodian.

The idea of vertical integration is to employ a single entity (normally the trustee or equivalent) to perform two or more of these functions. One-stop shopping is a useful arrangement in that it provides a range of different and professional services within one group, which implies simplicity and less complications for plan sponsors. Based on Decrees 20 and 23, vertical integration is

[11] The other 8 industries are transportation, communication, water, aviation, non-ferrous metal, construction, coal and (state-controlled) financial institutions.

permitted, although custody service may not be undertaken by the same company that serves as the asset manager.

In this context, it is observed that financial institutions in China are working together to introduce products attractive to SMEs. In early 2007, Pingan Insurance agreed with China Merchants Bank to provide the “2-2” arrangement mainly targeting SMEs in Jiangsu province, one of the richest provinces in China and where a large number of SMEs operate. According to this initiative, Pingan Insurance serves as the trustee and asset manager, while China Merchants Bank serves as the administrator and custodian. Due to the short history, it is not clear for the time being how successful this arrangement is, but it is a good start in terms of promoting CPFs in China (it should be noted that these two institutions received the fund transfer from the Shengzhen EA Administration Centre in January 2007, as discussed in Section 3.1.2a).

3.2. Problems holding back development of CPFs in China

Despite their importance in China’s economic fabric, SMEs have been left behind by recent EA reforms. For example, as of February 2006, statistics (Annuity 2007[12]) show that SMEs accounted for 55% of the overall GDP, 60% of exports, and 75% of total employment, while only 50 SMEs (out of 23 million SMEs in China) reported and registered their (new) EA plans with the local social security bureaus, and the corresponding EA assets were just 1% of the total EA asset accumulation.

What are the main obstacles holding back development of CPFs in China, particularly among SMEs? The key problems will now be discussed.

3.2.1 Structural obstacle

Based on Decree 20, the establishment of EA plans requires sponsoring firms to meet 3 criteria, i.e. having participated and paid social security contributions, being financially sound, and having a collective bargaining mechanism in place. However, the reality in China is that many SMEs try to avoid participating in and contributing to social security. Meanwhile, many SMEs do not have sound collective bargaining and internal redress mechanisms. For example, trade unions and regular meetings with representatives from both employees and employer are not common within SMEs.

3.2.2 Limited tax relief

Profit margins are much lower for SMEs than for state-controlled industries (e.g. electricity, railways etc.). Therefore the extra contributions required for EA plans on top of the compulsory pension contributions are a major negative disincentive to their provision by SMEs. This is particularly the case when employer contributions are only tax deductible up to a limit of 4% of payroll, while employee contributions (if any) are not tax deductible at all. Therefore, unless other ways are introduced to reduce the overall costs created by EA contributions (e.g. more tax benefits), SMEs will naturally avoid participating.

[12] http://www.annuity.com.cn/html/jhnj/

3.2.3 High administrative costs

Since 2004, the EA market in China entered a new era, following the release of the two Decrees with details regarding the procedures for setting up EA plans, capital requirements for the external EA service providers, investment limits, etc. On the one hand, the EA markets in China are becoming more regulated and developed; on the other hand, it reinforces the difficulty in establishing EA plans for small firms, given the potential high costs and lengthy procedure. Two particularly challenging barriers are the following:

a) Lack of qualified staff

Establishing EA plans requires staff who at least understand what EA plans are, and who have some basic knowledge of investment and finance related matters. Yet small firms tend to lack such suitably qualified staff. Hiring more qualified staff will obviously incur extra costs for the SMEs.

b) High management fee

Given the small size of EA assets accumulated within an individual SME, it is likely to be inefficient to operate single company funds relative to industry funds. Therefore, either the fees charged by service providers will be prohibitively high, or service providers may not seek EA business from SMEs.

3.2.4 Less awareness of EAs among SMEs

Another obstacle to the establishment of EA plans among SMEs is that many SMEs do not know and understand what an EA is. This is mainly due to less communication on EA plans being directed to SMEs, itself partly a result of seduced interest among SMEs for the above reasons. Wider investor education will be necessary.

3.2.5 Weak collaboration between ministries

Weak collaboration between different administrative regulatory and supervisory authorities has also been a hurdle to developing the CPF market in China.

As noted in Section 3.1, industry funds exist in China and are one of the key players in the market. However, how to transfer or transform such legacy funds into the new EA regime is difficult, as several ministries in China play a role in the administration and supervision of these funds.

The State-owned Assets Supervision and Administration Commission (SASAC) is the main administrator of the largest state-owned enterprises (SOEs) on behalf of the central government. Meanwhile, it is widely recognised that current tax relief benefits on EA contributions have discouraged sponsors from participating, but the power of setting tax policies belongs to the State Taxation Administration (STA) in China. In addition, the Ministry of Finance may have a say in this context, since the question as to whether to exempt some tax collections (e.g. tax on investment income) is within this Ministry's jurisdiction.

Meanwhile, whenever the development and design of new financial products as well as establishment of specialist financial institutions is involved, it is necessary to obtain permission from three separate and independent financial regulators in China, i.e. China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), and China Securities Regulatory Commission (CSRC), as well as People's Bank of China. For example, trust products offered by trust companies in China are regulated by CBRC, while CSRC oversees the mutual fund markets. In addition, any insurance company wanting to set up specialist subsidiaries for the purpose of conducting EA business (i.e. consistent with rules in Decrees 20 and 23) must obtain permission from CIRC.

Overall, the current regulatory regime in China has been hindering the development of EA markets in general and CPFs in particular. Therefore, a more collaborative supervisory environment is needed to promote its development.

4. How to establish CPFs in China

Above, we discussed the problems holding back the development of CPFs in China. Given these issues, and whilst bearing in mind the specific conditions in China as well as the experience of selected OECD countries and Hong Kong, China, we propose the following practical policy recommendations regarding how to promote the growth and development of CPFs in China. In general, given the complexity of the current situations in China, reforms should combine the efficient use of existing collective pension arrangements with new initiatives for wider participation of the private sector, which in turn is discussed according to the two permitted models (internal pension council and external corporate trustee).

4.1 Internal model (Pension Council)

As reviewed in Section 3, CPFs have existed in China for some time. In view of developing CPFs further, particularly among the SMEs with different business activities and locations. it is recommended that the current existing mechanisms should be fully explored and used. To this end, for example, the industry funds and local EA administration centres could be considered to be potential channels through which employees in SMEs join EA schemes. The largest benefit of using such existing mechanisms is the ease of establishment and the subsequent lower costs than would be normally be incured when setting up a completely new mechanism. In this context, MOLSS might consider utilizing existing industry funds and local EA administration centres - subject to these providers meeting the requirements of the new EA legislation. It should be noted that as the largest SOEs (covering almost all of the monopolistic industries, e.g. electricity and mining in China) are under supervision of the SASAC, cooperation between MOLSS and SASAC would be necessary.

4.1.1 Existing industry funds

One approach to establish CPFs in China for the SME sector would be to allow EA-compliant existing industry funds to open their membership to non-related plan sponsors. All SMEs regardless of industry affiliation could be entitled to join. As reviewed above, the Australian superannuation industry recently witnessed such a trend as industry funds begin to become open to non-related companies (including SMEs). SMEs that do not want to set up their own company pension schemes can benefit from economies of scale offered by the industry funds, thus saving costs.

The Chinese authorities have been engaged in reforms relating to the major national industry funds in China, aiming to restructure these funds so that they meet the requirements stipulated in Decree 20 (2004). Therefore, since efforts (from both government and industry) have already been spent on these CPF arrangements, it may make sense to take an extra step and broaden these funds' membership. For example, MOLSS might consider allowing (or even encouraging) an existing industry fund in China (e.g. the Electricity Industry Fund) to accept employees from other industries (including SMEs). This might be one of the fastest ways to include employees in SMEs in the formal EA system. Regarding the governance structure, initially it would be appropriate for the existing governance structure to remain in place (e.g. representatives from the electricity industry dominate the board), while in the future, if and when the industry fund has undergone significant changes, notably regarding membership, the governance structure should reflect such changes correspondingly, for example, having a more balanced representation with members or representatives of other industries also having a place on the trustee board or advisory body, or introducing some mechanism to ensure their voice is heard (for example at an annual meeting).

4.1.2 New industry funds

Another, somewhat slower way to promote the CPFs is by setting up new industry funds, rather than using the above-mentioned existing industry funds. This approach might be appealing to the industries concerned, given the fact that they are expected to be fully involved in establishment of the funds, therefore having more control over them. Nevertheless, the establishment of new industry funds should again rely on the existing collective bargaining mechanisms, for example via industry associations. It is observed that such associations operate widely across the country, although some are structured loosely, while others are more organised. International experience shows that successfully using such associations to establish collective pension schemes is possible, e.g. Australia and the Netherlands where industry associations played an important role in setting up industry funds.

In view of the current central government's priority on welfare of rural migrant workers (which refers to a population amounting to approximately 200 million and with an average age in their 20s), MOLSS might consider designing a pilot scheme in the areas where such rural migrant workers are concentrated, e.g. Guangdong and Zhejiang. On the one hand, this initiative meets the agenda of the central government, and therefore might be able to receive support (both financially and politically); on the other hand, it helps MOLSS in building experience for similar situations elsewhere in the country. Indeed in Hong Kong, China and in other countries such as the United States, industry funds have been a popular choice for these mobile workers, for example those working in the construction and catering industries.

4.1.3 Regional administration centres

It was noted above that the Chinese authorities have decided that the regional social security bureaus should give up management of EA funds and transfer such funds to market participants by the end of 2007. Given this decision it is a good time for the Chinese authorities to link such policy initiatives with the goal of promoting CPFs in China. Our recommendation is that the Chinese government might consider reconstructing the local EA administration centres initially to be qualified EA trustees (i.e. collective pension councils), and then opening participation to SMEs in the specific localities. For the regions where such local administration centres are not available, MOLSS might consider encouraging their establishment. Such an arrangement may be appealing to the three key participants of the CPF arrangements, i.e. employees/employers, the local government and the MOLSS.

From the point of view of SMEs, they would have incentives to join such re-structured local EA administration centres, given their logistical closeness to such centres and the administration centres' local orientation, which is particularly important at the early stage of their development.

From the point of view of the local governments, they might be also interested in such initiatives, as they would maintain some control over these local pension assets, given the proposed governance structure of the new local EA administration centres, as discussed below, in comparison to the corporate trustee model (see the next section for details).

From the point of view of the MOLSS, the establishment of local administration centres as qualified trustees might facilitate supervision, as these activities would already come under the purview of social security bureaus.

<u>a) Governance structure of the proposed regional EA administration centres</u>

It is proposed that the re-structured local EA administration centres should serve as the trustees, who have the ultimate responsibility of administrating and managing the EA assets, although if deemed necessary, they can outsource other functions to the external professional service providers, e.g. the EA asset management function could and probably should be outsourced to professional asset managers. The trustees of the regional EA administration centres could be structured along the internal, pension fund council model, or as an external trustee (as what Shanghai EA Administration Centre mentioned earlier). In this section, we focus on the former, since the latter will be discussed in detail in Section 4.2.

This governance structure would have to be handled carefully in order to avoid the problems with the trustee models identified previously.

First, employee and employer representation on the pension council would need to be established. Although equal representation is normal in OECD countries, there are no immediate and compelling arguments to change the current Chinese EA legislation where it is stipulated that at least 1/3 of the trustees should be from employee representatives. Given the diversity of participating firms in the context of CPFs, it is recommended that existing collective bargaining mechanisms should be used. For example, given the wide existence of the local trade unions at different levels (i.e. municipal, provincial) in China, it is advisable that members from the trade unions sit on the regional EA administration centre board of trustee, given their experience of speaking on behalf of local employees. Regarding employer representatives, they should come from the existing industry associations and/or the largest participants in terms of size and asset. Note that from a practical perspective, it might not be optimal (or even possible) for every single participating firm to have its direct representatives sitting on the board. Therefore the priority could be given to the largest plan sponsors, although smaller plan sponsors could still have their more direct "voice", if the industry association of those smaller sponsors is available in the specific localities. Alternatively, it is also recommended that key issues relating to the funds could be voted at the annual general meeting (AGM), in which case members regardless of size are given the opportunity to raise their concerns and take part in the decision making process.

Second, in order to ensure the smooth running of the local pension funds, inappropriate state intervention should be avoided. However, there might be the possibility of government representatives sitting on the board, as a way of overseeing the funds as well as with the aim of receiving support from the local governments on this initiative. In this context, government representatives could act as the standard independent trustee who does not have the casting vote. Except for the government representatives (if any), employees and employer representatives should be nominated via the appropriate mechanisms (e.g. AGM), rather than being appointed by the largest employers and industry associations, as a way to ensure that the voice of the smaller employers is heard.

b) Risk control

The proposed pension council model for EA administration centres seems an appropriate choice for SMEs, since it may be able to protect better the interests of beneficiaries. However, one question is whether capital requirements are necessary for pension councils, as for external, commercial trustees? One reason for not setting such minimum capital requirements is that pension councils are not financial and/or commercial organisations, and are instead operated on a "not-for-profit" basis. Therefore, they might not be able to afford the financial requirements if such capital requirements are set to be as high as those imposed on the financial institutions. However, in order to control risks, and subject to availability, commercial insurance might be utilised as in the case in Hong Kong, China and Australia. In other words, trustees buy indemnity insurance from insurance providers to cover any potential loss which might arise. However, as in other countries, if such loss is due to dishonesty and deliberate misconduct, trustees should not be covered by the insurance policy, but subject to legal charges, since they did not fulfil their fiduciary duties.

4.2 External model (Corporate Trustee)

As reviewed in the earlier case studies, the private sector plays a very important role in CPF arrangements in most OECD countries. When promoting and developing CPFs in China, full consideration should be given to participation by the private sector, in light of their experience in managing EA assets. As stipulated in Decree No. 23 regulation in 2004, a professional trustee refers to a professional financial institution which is licensed by MOLSS to conduct the trusteeship business – therefore giving the private sector a role in the EA market.

At the moment, it is understood that the private sector (e.g. insurance companies and asset managers) is interested in developing the SMEs aspect of the pension fund market in China, although it still sees many obstacles which have delayed the take-off and development of the CPFs. The key feature of the professional trustee model is that financial institutions serve as the trustees which are operated on a "for-profit" basis. In this case, trustees can outsource the professional functions to other service providers, but the ultimate responsibility and fiduciary duties cannot be outsourced. This arrangement has been popular in some OECD countries as well as Hong Kong, China.

4.2.1 "One-stop shopping" arrangement

"One-stop shopping" involves the vertical integration of various functions related to the operation of the pension fund within a *single* entity, and is permitted under the current Chinese legislation, except for the case of custodian services which cannot be conducted by the asset manager. One-stop shopping is a useful arrangement in that it provides a range of different and professional services within one group, which implies simplicity and less complications for plan sponsors.

In several other countries throughout the world, it is common for the main three pension related services (i.e. administration, asset management and trusteeship) to be performed by a single entity, especially for SMEs. There are the obvious potential advantages of cost reductions and avoidance of overlaps and vacuums in the allocation of activities between separate parties. Vertical integration of functions for a single pension plan within a single pension entity can also help resolve certain issues about individual and ultimate responsibilities. On the other hand, it may increase the possibilities for abuse – resulting from so many powers (including discretionary powers) being allocated to a single body without, possibly adequate checks and balances.

Nevertheless, it is recommended that such arrangements should continue to be allowed in the context of CPF legislation – on the basis that the advantages of such arrangements are greater than the disadvantages, as long as the private sector is subject to efficient and effective supervision. Indeed, in OECD countries, such "one-stop shopping" is common, and has served as one of the main mechanisms through which employees in SMEs can access occupational pensions on a cost-efficient basis (for example via SEPs in the United States). In Hong Kong, China, the regulation even allows the full vertical integration of the four services, i.e. trust management, asset management, record-keeping and custodian service. Although the investment managers should be different entities from the trustees and custodians, they can all be part of the same financial institution.

4.2.2 Governance structure

The private sector should play an important role in China's CPF arrangements. However, there are some potential problems. For example, costs are not always transparent, particularly given the information asymmetry between service providers and plan sponsors. Consequently fees and charges are often higher than in other types of schemes (which has a large impact on the eventual pension received). Experience from other pension markets suggests that representatives from employees and employers should have their "voice" heard to some extent during the decision making process regarding the appointment of professional trustees. For example, one option for consideration in the Chinese context is an advisory board with employee and employer representatives, overseeing the appointment of external service providers. Such a board may be required if more than a certain number of employees (e.g. 50) from the same firm are due to be enrolled in a pension plan as in the case in Australia. In any case, it should be stressed that beneficiaries of the plans (i.e. employees under the China's DC based EA plans) should be actively involved in the selection process of external trustees, as they are the ultimate risk bearers and may pay for much of the cost of management of these plans.

4.2.3. Risk control

Given the different nature of professional trustees and pension councils, different risk control mechanisms could be used. As specified in Decree 23, minimum capital requirements should be imposed on the financial institutions which apply for corporate trustee licenses. Such a requirement which is common in OECD countries and Hong Kong, China not only indicates a commitment by the financial institutions, but also serves as a buffer against various operational risks. For example, in Australia, it is required that the trustee of a publicly offered fund should have a minimum capitalisation of AUS$ 5 million, while this requirement is HK$ 150 million for the MPF system in Hong Kong, China. In addition, as with the pension council model, trustees should be required to purchase indemnity insurance to serve as an extra layer of protection. Meanwhile, in Hong Kong, China, 0.03% of assets are deducted from the scheme assets, as a form of compensation levy.

5. Conclusion

In this paper, we have reviewed and discussed China's occupational pension (Enterprise Annuities, EA) system in general and collective pension funds (CPFs) in particular. CPFs already exist in China, in the form of industry funds (e.g. electricity funds), and regional EA administration centres. However, recent statistics show that 99% of the EA assets accumulated were from the profitable large state-owned enterprises, despite the fact that SMEs accounted for 55% of the overall GDP and 75% of total employment in China (as of February 2006).

Some of the main reasons SMEs are reluctant to establish EA plans include the lack of collective bargaining mechanism (highlighted by lack of regular communication mechanism between trade unions and the employers), and high administrative costs (for example the costs involved in lengthy procedure of setting up internal pension councils or high fees charged by external financial institutions). Given the international experience reviewed in this paper, while bearing in mind the Chinese current situations, we propose the following options regarding how to bring SMEs to the EA system in China:

1) Existing industry funds could open their membership to other companies (including SMEs in unrelated industries). This may be the fastest way to bring employees in SMEs into the formal EA system in China, although only those industry funds which have been restructured to meet Decrees 20 and 23 would be permitted to open up their membership.

2) Along the lines of the above point, new (purpose-built) industry funds (with open or closed membership) could be established, as long as a collective bargaining mechanism is in place. In this case, industry associations and trade unions at different levels should play the lead role.

3) Regional EA administration centres could be set up under the framework of an internal pension council. Such a development could be integrated into the government's plan to externalise the EA assets managed by the local EA administration centres by 2007. Given the our proposed governance structure proposed in this paper (involving employer and employer representation as well as non-voting government advisors), all the key parties involved in these restructured regional EA administration centres would have incentives to participate. These CPFs may be a viable and less costly alternative to those established by commercial trustees. As cost considerations are critical for SMEs, the promotion of low-cost CPF arrangements would go a long way towards extending the coverage of the EA system to employers in this sector.

4) Private sector financial institutions acting as external trustees should be encouraged to offer open CPF products. This is not only in line with international experiences (e.g. the active role played by insurance companies and asset managers in OECD countries), but also consistent with the expertise developed by the private sector in China in managing pension assets. The upcoming new legislation on CPFs in China will have a focus on corporate trustees.

Annex: Detailed description of CPFs in Australia, Hong Kong (China), the Netherlands and the United States

Annex A1. Australia

1. Overview of occupational pension markets in Australia

The Australian occupational pension market (called the superannuation fund market) is arguably one of the world's most developed and sophisticated markets. Participation in occupational pensions in Australia is compulsory for most employees and is encouraged through tax incentives for all. Broadly speaking, there are various types of superannuation funds in Australia as follows:

- Corporate funds which are employer-sponsored superannuation funds generally restricted to employees of the sponsoring employer.
- Industry superannuation funds which were originally open only to employees in companies within a certain industry.
- Public sector funds implementing schemes that cover public sector employees.
- Master trusts which are offered to the public and to employers by financial service providers.
- Self managed superannuation funds (SMSFs) which are funds with fewer than five members, where each member is also a trustee of the fund and none of the members are arms length employees of other members. Such funds are not prudentially supervised given the identity of interests.
- Retirement saving accounts (RSAs) which are a contractual form of low cost saving similar to term deposits. They are capital guaranteed products offered by deposit taking institutions or life insurance companies.

Of all the different funds above, the SMSFs have witnessed rapid growth in recent years, due to increased demand from individuals on choice of investment, while the number of corporate funds has decreased following new regulation on the licensing of trustees in 2006.

2. Profile of collective pension funds

Both industry funds and master trusts exist in Australia.

Industry funds draw members from a range of employers across a single industry (or group of related industries) and are usually established under an agreement between the parties to an industrial award. Industry funds are similar to corporate funds, in that they have standard employer sponsors and are traditionally "non-public offer" (closed funds). In recent years many industry funds have become "public offer", meaning that they are open funds and members from the general public (including SMEs) can now join. Industry funds that are public offer, however, still have the vast majority of their members from the industry for which the fund was established.

There were 82 industry funds in Australia as of September 2006 and the total amount of assets under management was AUS$ 162 billion (i.e. 17.2% of the market share). Examples[13] include

- BUSSQ (Building Unions Superannuation Scheme (Queensland), which provides benefits for all employees in the Queensland building and construction industry
- CARE Super, which targets people engaged in professional, managerial, administrative, service and related occupations (it is now a public offer fund, therefore open to SMEs)
- Asset Super, which as a multi-industry public offer fund, covers employees in various sectors and professions, , e.g. vineyards, doctors/dentists, charities and internet companies

In Australia, the most common form of industry funds is a multi-industry fund, which has traditionally covered a range of related industries but now is becoming more dispersed. For example, the former Australian Retirement Fund (ARF) used to cover textile clothing and footwear, cleaning and printing industries, etc. In July 2006, the Australian Retirement Fund (ARF) and the Superannuation Trust of Australia (STA) merged and became one of the largest multi-industry funds in Australia. Accordingly, the new fund (renamed as AustraliaSuper) covers a diverse range of industries, including automotive, metal, cleaning and training, etc.

Master trusts are superannuation entities that offer superannuation products to the public on a commercial 'for profit' basis. Master trusts are usually run by large financial institutions which provide a range of wealth management products. Included in the retail category are large public offer superannuation trusts that comprise a number of smaller funds (sub-funds) that have been consolidated into the larger trust. These entities are commonly known as superannuation master trusts and have become increasingly popular over the last few years. Multi-member approved deposit funds and eligible rollover funds are also considered to be master trusts. As of September 2006, 186 master trusts were operated in Australia with assets under management at AUS$ 306 billion (representing 32.4% of the total market; the largest market player).

3. Institutional Framework

Since June 2006, all trustees operating an APRA (Australian Prudential Regulation Authority) regulated superannuation entity must hold a Registrable Superannuation Entity (RSE) License, but trustees of self-managed superannuation funds regulated by the Australian Taxation Office (ATO) and some public sector superannuation schemes are exempted from this requirement. In addition, all superannuation entities except for the self-managed superannuation funds and some public schemes should register with the APRA. Only an RSE licensee can register a superannuation entity[14].

<u>Industry funds</u>

For non-public offer industry funds (and other standard employer-sponsored funds) in Australia, there is a requirement of equal representation of employees and employers on the board of

[13] IFF (Industry Fund Forum) (2007). Members of IFF; http://www.industryfunds.org.au/index.cfm?contentid=432'; Accessed on 05 March 2007.

[14] Australian Prudential Regulation Authority. http://www.apra.gov.au/Superannuation/; accessed on 03 April 2007.

trustees or the group of individual trustees. In this case, the employee (employer) representatives should be nominated by the employees (employers) of the fund or organisations representing the interests of the employees (employers), and they are not necessarily the members of the fund.

Regarding public offer industry funds, trustees should be structured either:

- meeting the equal representation requirements on employees and employers; or
- having an independent trustee and complying with rules relating to policy committees of an advisory nature (i.e. these committees should have equal numbers of employee and employer representatives).

Meanwhile, based on the current legislation on non-public offer funds, it is possible to have an additional independent trustee or trustee board director, with the basic equal representation rules still being met. A trustee or director is defined as “independent”, if he/she is

- not a member of the fund;
- not an employer-sponsor or associate of an employer-sponsor of the fund;
- not an employee of an employer-sponsor of the fund or an employee of an associate of such an employer-sponsor;
- not in any capacity a representative of an organisation, such as an trade union, representing the interests of one or more members of the fund; and
- not in any capacity a representative of an organisation representing the interests of one or more employer-sponsor of the fund.

The general practice is that only one additional independent trustee or board director is appointed. However, it is possible to appoint more than one trustee if it is approved by the board and APRA. Meanwhile, the additional independent trustees or directors have a deliberative vote, rather than the casting vote. In other words, when equality of votes happens, they cannot have an additional “second” vote.

When public offer funds decide to establish policy committees, there is no scope to appoint additional independent representatives from either employees or employers to these committees, since by definition the trustee is already independent.

In addition, any unreasonable restriction in preventing certain groups of members from being nominated is not allowed. However, the current legislation allows setting quotas for member representatives from specific sites or geographical locations in order to ensure appropriate representation of all classes of members within a fund.

Trustees should purchase appropriate insurance against any liability to which they may be exposed when they conduct their fiduciary duties. However, there are legal exceptions where such indemnification does not apply, i.e. when trustees

- act dishonestly in relation to the fund;
- recklessly or deliberately fall to exercise the degree of care or diligence that a trustee is required to exercise; or

- are subject to a monetary penalty under a civil penalty order.

Master trusts

When discussing public offer (open industry) funds above, mention is made of the fact that trustees could be independent, which implicitly refers to master trusts where commercial trustees are in charge. In this regard, the current legislation allows (not requires) the establishment of "policy committees" where there must be equal representation of employee and employer representatives. However, when there are 50 or more members with the same or an associated employer-sponsor (a "group"), at least one policy committee should be set up for that group.

Establishment of policy committees is in theory a way to monitor the performance of the independent trustees and the main functions are to advise and inform the trustees on issues which are raised by members or employer-sponsors of the particular fund. However, the ultimate fiduciary duties still remain with the independent trustees, and policy committees cannot limit trustees' ability and responsibilities of fulfilling such duties. It has been observed that the policy committee is largely operated as an advisory board and is not generally involved in daily operation of retails funds in Australia.

Meanwhile, for master trusts, the "one-stop shopping" model is common, in that trusteeship, account administrator and/or asset management are conducted by different/separate subsidiaries of the same large financial institution. For example, the Aon Master Trust was established in 1990 in Australia. The trustee of this master trust is Aon Superannuation Pty Limited (a wholly-owned subsidiary of Aon Corporation), while the account administrator is Aon Consulting Pty Limited (also a wholly-owned subsidiary of Aon Corporation). Meanwhile, consulting services of the Aon Master Trust are provided by Aon Consulting Pty Limited as well. In terms of members of trustee board, they are mainly from and appointed by the financial institution, while employer-sponsors play a less significant role in this context. Board members are normally paid, and their remuneration is determined between the sponsoring financial institution (e.g. Aon Corporation) and the subsidiary trustee (e.g. Aon Superannuation Pty Limited).

Due to commercial trustees' knowledge and expertise on finance and investment, it is argued that they are able to provide better professional service and offer more (even tailor-made) investment options for customers, when compared to industry funds. However, due to their "for-profit" nature, the fee charged by the former is normally higher than that of other funds. Some statistics show that large industry funds tend to be the lowest cost operators in the superannuation sector in Australia.

4. Key characteristics

4.1 Strong position of industry funds

Industry funds are an important player in Australia's superannuation system. In terms of total number of member accounts, over one-third (i.e. 9.7 million out of 28.9 million) belonged to industry funds as of June 2006. When it comes to total assets under management, the difference is less marked, in that it accounted for 17.2% of the total superannuation assets in 2006. This ratio, however, increased from 16.0% in 2005, following the asset inflow from corporate funds.

4.2 Increasing popularity of master trusts

As of 2006, master trusts were the most popular superannuation arrangement in Australia, in that their assets represented 32.4% of the total market, while the ratio was over 50% in terms of number of member accounts. Its popularity might be due to professional service and richer investment choices for investors as well as the "the brand reputation" and cross selling of services within a group.

4.3 Equal representation of employee and employer representatives

The concept of equal representation has been implemented in Australia. For example, for non-public offer funds, equal numbers of employee and employer representatives should sit on the board of trustees or group of individual trustees. For the public-offer funds or where an independent trustee is hired, or when more than 50 members come from the same or associated employer sponsor, policy committees with equal representation of employees and employers should be established.

4.4. Licensing requirement

Since June 2006, the APRA requires that all superannuation trustees demonstrate to APRA that they have adequate resources (staff, technology and financial) and appropriate skills and expertise to manage superannuation funds, as described in the earlier section. The licensing requirement is utilised to improve robustness of the superannuation system and protect beneficiaries' interests.

5. Main merits and weaknesses:

5.1. Merits

First, active involvement of trade unions and relevant industry associations helps and sustains the development and growth of industry funds in Australia. As noted, whether the trustee of the industry funds is structured as a group of individual trustees or a corporation, interests of employers and employees should be represented. In this context, trade unions and industry associations have played a leading role in Australia.

Second, equal representation of employees and employers has been implemented in Australian CPFs, in that for industry funds, equal numbers of employee and employer representatives have to sit on the board of trustees, while for the master trusts, the same policy has to be implemented on the board of policy committees.

Third, the private sector has played an important role in Australian CPFs, which to some extent enhances beneficiaries' benefits, for example by providing more innovative investment products and choices for members.

5.2 Weaknesses

First, although equal representation has been achieved on the board of trustees of industry funds, it is noted that many of the representatives are nominated by the largest trade unions or industry associations. Therefore, does it imply that employees and employers of the smaller employers are under-represented on the board?

Second, in the master trusts, all trustees are appointed by the financial institutions, and members and employer sponsors cannot remove them if their performance is not satisfactory. The only solution is to switch to another fund.

Third, cost is also a concern for the master trusts in Australia, which typically are among the highest cost superannuation operators, although they may possibly provide better services. Industry funds have historically provided higher net-of-fees returns to members than master trusts.

6. Challenges:

For industry funds, the main challenge is how to ensure representation of employees and employers by size of employers (i.e. the current system is dominated by largest ones). For master trusts, how to align commercial interests and fiduciary duties is a difficult question. Meanwhile, action should be taken to have policy committees (set by the commercial trustees) more involved in the running of the funds.

Annex A2. Hong Kong, China

1. Overview of the Mandatory Provident Fund in Hong Kong, China

In Hong Kong, China the Mandatory Provident Fund (MPF) system was first introduced in 1995 when Hong Kong, China decided to implement the multi-pillar pension system, and became operational in 2000. As of end of 2006, 232,000 employers participated in the MPF, and there were around 2.4 million members. The total assets amounted to HKD 202 billion, representing around 13.7% of GDP.

The MPF system is based on mandatory, defined contribution pension fund managed on a collective basis. Employers and employees each contribute 5% of the employee's relevant income to a registered MPF scheme, subject to the maximum and minimum levels of income for contribution purposes. The self-employed must also contribute 5% of their relevant income. The accrued benefits are fully vested in the scheme members and can be transferred from scheme to scheme when workers change employer or cease to be employed. Under normal circumstances, benefits must be preserved until the scheme member attains the retirement age of 65. Contributions, investment income and benefits are all tax exempt. Funds are managed by private sector fund managers. Employers choose both trustees and MPF schemes for their employees, although employees have the right to choose the constituent/investment funds within each MPF scheme. Most schemes offer four to six constituent funds, varying from conservative to aggressive, and must include a capital preservation fund as one option. Strict quantitative and qualitative restrictions apply to the investment of funds, but these are under constant review in the light of the market development. The Mandatory Provident Fund Schemes Authority (MPFA) regulates and monitors the operation of the MPF system and MPF trustees' compliance with statutory requirements. The MPF system has become the main retirement protection system in Hong Kong, China.

2. Plan profile of the MPF schemes

There are three types of MPF schemes in Hong Kong, China, and two of them are sort of collective pension arrangements, while the other one is the standard single employer-sponsored pension scheme.

Employer-sponsored scheme: This refers to the occupational mandatory provident fund scheme sponsored by a single employer (and its associated companies), the membership of which is only open to the employees of this employer (and of its associated companies). At the moment, there are only two employer sponsored schemes in Hong Kong, China, and they are Jones Lang Lasalle Property Management Division MPF Scheme and SHKP MPF Employer Sponsored Scheme.

Industry scheme: At present, two industry schemes exist for the catering and construction industries, and they are only open to employees and self-employed persons in the two industries. The reason for establishing industry schemes is mainly due to the high labour mobility and turnover in the two industries. Therefore, if a person changes jobs but stays within the same industry, he/she does not need to change pension schemes. Accrued pension rights are fully portable within the industry. Employers in the two industries may choose to enrol their employees in the industry schemes, or in the other two types of schemes, i.e. employer-sponsored schemes or master trust schemes. Examples of coverage for these two industries are as follows:

Catering industry
- Food factories, milk factories
- Restaurants
- Chinese herbal tea shops

Construction industry
- Civil engineering
- Refurbishment and maintenance and other similar works
- Gas, plumbing, drainage and other similar works

Master trust scheme: This is the most popular form of mandatory provident fund arrangement in Hong Kong, China, and the membership is open to the employees of more than one employer, self-employed persons and persons with accrued benefits transferred from other schemes. By pooling the contributions of small employer units together for administration and investment, such master trust arrangements may have a high degree of efficiency resulting from economies of scale.

3. Institutional Framework

In general in Hong Kong, China, public and private-sector employees and self-employed persons aged between 18 and 65 must become members of a provident fund scheme. This obligation applies to full-time and part-time workers holding a contract of 60 days or more. Meanwhile, every employer must enrol all employees in a mandatory provident fund scheme within 60 days of the employment commencing (10 days in the case of casual employees of the construction and catering industries).

All MPF schemes in Hong Kong, China have to be established under a trust with trustees approved by the MPFA. In this context, trustees could be corporate trustees or a group of individual trustees.

A registered trust company incorporated in Hong Kong which applies for approval as trustee must:

- Comply with the prescribed capital adequacy requirements;
- Have at least five directors of which all must be individuals;
- Have sufficient presence and control in Hong Kong;
- Satisfy the MPFA that it is capable of carrying out the business of administering registered schemes for which purpose the MPFA may enter and inspect the premises intended to be used by the company for carrying out the business of administering registered schemes;
- Not engage in any other business than trust business;
- Satisfy the MPFA that all of the controllers of the company are persons of good reputation and character and, in particular, have not been found guilty, whether in Hong Kong or elsewhere, of an offence involving fraud or dishonesty;
- Satisfy the MPFA that the chief executive officer and a majority of directors (which must include an independent director) of the company have collectively the skill, knowledge

and experience that are necessary for the successful administration of provident fund schemes.

As noted above, in order to ensure efficiency of the (corporate) trustee, current legislation requires that at least one member of the trustee board should be independent director. For this independent director, he or she must meet the following criteria:

- Not be an employee or partner of the trust company, or of an associate of the trust company;
- Not be a director of an associate of the trust company;
- Not hold any shares of the trust company or of any associate of the trust company;
- Satisfy the MPFA that there is no past or present association (financial or otherwise) that could affect his/her impartiality.

A registered trust company incorporated in Hong Kong and a company incorporated outside Hong Kong must accompany the application with a written report prepared by an auditor appointed by the applicant that must state whether or not the applicant complies with the prescribed capital requirements of:

- Having a paid-up share capital of at least HKD 150 Million;
- Owning net assets of at least the same amount;
- Owning assets held in Hong Kong to the value of at least HKD 15 Million.

Key responsibilities of the trustees include:

- Select asset managers and monitor their performance on an ongoing basis;
- Manage the contribution and benefit administration themselves;
- Appoint a custodian to hold the scheme assets (an approved trustee may be custodian under specific circumstances);
- Establish a separate individual account for each scheme member;
- Ensure that each member's account is kept in such a manner that the market value of the accrued benefits of a member can be ascertained at least once a month.

According to the current legislation, there is no requirement regarding representation of employees and employers on the plan’s board of trustees for all three forms of MPF schemes, although the MPFA itself has a statutory committee consisting of equal number of representatives from employees and employers. In order to ensure the efficient operation of the trust-based MPF system, the MPFA adopts a risk-based supervisory approach, which is complemented by on-site visits and off-site monitoring as well as a set of compliance standards on trustees and guidelines on investment and scheme operation etc. Meanwhile, in order to meet the potential losses suffered by the beneficiaries, e.g. due to fraud of trustees, 0.03% of the MPF assets are deducted from the scheme assets as the compensation fund levy. If in any case, the compensation funds are insufficient funds to cover the losses, the Financial Secretary may provide grants or loans out of the general government revenue.

In this context, the trustee(s) must have adequate insurance in respect of a registered scheme, so that beneficiaries could be indemnified against losses as a result of the maladministration of the scheme by a trustee or by any service provider appointed to the scheme. Such insurance should cover a specified amount/percentage of the total assets under management by the trustees. However, if the insurance policy stipulates that the insurer is liable for only the part of a claim that exceeds a specified amount (known as the deductible amount), this deductible must not exceed:

- HKD 100,000 if the market value of the trustee(s)' total assets under management is not more than HKD 1 Million;
- The lower of HKD 500,000 and 10% of the market value of the scheme assets if the trustee(s)' total assets under management exceed HKD 1 Million.

4. Key characteristics

Overall, the MPF system in Hong Kong, China has collective pension arrangements for two of its components, i.e. industry funds and master trusts. Its key features are as follows:

4.1 High participation rate

Since its inception, the MPF system has achieved a very high participation rate. For example, as of March 2007, the rate was 99.8% for employers, 97.5% for employees and 75.6% for self-employed persons. This is mainly due to the fact that participation in the MPF schemes is mandatory according to the current regulation.

4.2 Popularity of the master trust schemes

As noted in the earlier sections, the MPF system has three components, but the most popular one is the master trust scheme. For example, as of March 2007, of 40 existing schemes, 36 were the master trust schemes, with two industry schemes and two employer-sponsor schemes. Meanwhile, out of the 318 constituent funds, 295 were with the master trust schemes, while the remaining 23 were with industry schemes and employer sponsored schemes.

4.3 Important role played by the private sector

In Hong Kong, China, the private sector is playing an important role in the occupational pension markets. For example, service providers can be a group of individual trustees or corporate entities. Furthermore, in this context, corporate trustees play the most important role, since as of March 2007 the MPFA did not receive any application from individuals for the trustee licenses.

4.4 Licensing requirements for service providers

Since the introduction of the MPS system in Hong Kong, China, trustees (individual or corporate) need to be approved to carry on the MPF-related businesses by the MPFA. As of March 2007, there were 19 corporate trustees.

5. Main merits and weaknesses:

5.1 Main merits

First, partly due to the extensive participation of the private sector in the MPF system and also economies of scale, small and medium size employers have been able to join the MPF without incurring too much cost. It is mainly achieved through the provision of master trusts by the financial institutions.

Second, asset management benefits from professional expertise. Since all the approved trustees (individual or corporate) have to satisfy the MPFA that they have skill, care and qualification of managing the MPF assets properly, it might to some extent ensure the professional management of the assets. It is particularly noticeable in the case of Hong Kong, China, that only corporate trustees are used by the MPF schemes.

5.2 Main weaknesses

First, the potential risk of conflict of interests exists within the MPF system in Hong Kong, China. The current legislation allows such vertical integration where the custody and other services are combined in one institution. For example, Bank Consortium Trust (BCT) serves as the trustee, administrator and custodian of their managed MPF schemes, but the investment managers are still different financial institutions (i.e. not part of the BCT group). Although it is claimed that such "one-stop shopping" has the benefits of cost efficiency, it does have potential problem of conflict of interests, and indeed in many other countries, the custodian is always separate from other service providers. Meanwhile, as noted in the preceding section, on the one hand, heavy use of professional corporate trustees could benefit from their specialist knowledge and expertise; on the other hand, the question as to how to align the commercial interests with their fiduciary duties is difficult to answer.

Second, relatively high level of fees has been observed in Hong Kong, China, and it is one of the main concerns for employees and members, since such charges and fees could reduce a significant portion of the returns achieved by the financial institutions. This issue is particularly important for pension fund assets given their long investment horizon.

6. Challenges:

Similarly to the master trusts in Australia, the question regarding how to ensure independent governance for the master trusts and align commercial interests and fiduciary responsibilities remains a big challenge for policymakers. In this context, the related point of high costs needs to be addressed.

Annex A3. The Netherlands

1. Overview of occupational pension markets in the Netherlands

Although there is no obligation for employers to set up supplementary pension plans for their employees, besides the compulsory old-age pension provisions (AOW), over 90% of employees in the Netherlands are covered by three main types of occupational pension plans.

The three types are company pensions, industry-wide pensions and professional pensions. Company pension plans financed through stand-alone pension funds, are largely set up by the large enterprises, like Royal Dutch Shell and Philips. Industry-wide pensions are mainly established for employees and employers in a particular industry, and could become compulsory subject to collective agreements between employers and employees and authorisation from the government. Professional pensions mainly target self-employed employees in a particular profession. The Dutch government can also make participation in a pension scheme for a professional group mandatory for the profession as a whole, if under the request of an organisation or organisations representing a sufficient majority of the profession concerned.

According to the existing legislation, pension commitments have to be financed on the basis of capital funding, and be kept outside of the balance sheet of the sponsoring companies. This could be achieved either in the form of a pension fund or by entering into an agreement with insurance companies. Meanwhile, by the legal requirement, pension assets have to be able to meet liabilities at a certain level. This requirement is particular relevant in the Netherlands, in that 90% of occupational pension members still participate in defined-benefit schemes.

2. Plan profile of the industry-wide pension schemes

The CPFs in the Netherlands, with a history of several decades, are mainly organised in the form of industry-wide pension funds. Indeed, industry funds are a popular pension arrangement in the Netherlands, and over 80% of the work-force who participate in occupational pensions in the Netherlands is covered by the industry-wide pension funds. At the moment, there are more than 70 industry-wide pension funds.

As implied by the name, industry-wide pension funds are normally open to members in a particular industry. Typical examples include

- The Stichting Pensioenfonds ABP: The largest pension fund in Europe covers employees working for the Dutch governments and the educational sector.
- PGGM: The 2nd largest pension fund in the Netherlands, and provides pension services for employees in the healthcare and social work sector.
- Horeca & Catering: One of the largest pension funds in the Netherlands, and its participants are mainly from the hotel, restaurant and catering industry.

Popularity of the industry funds largely originates from the historical reason of open and constructive social dialogue mechanisms between employers and employee in the Netherlands, under which representatives of employees and employers have a good reputation in representing the interests of their respective parties. Therefore, both employees and employers have a positive view on the establishment of industry-wide funds.

3. Institutional Framework

Pension funds (including industry funds) in the Netherlands are established on the basis of a pension foundation. The main difference between a foundation and a trust (on which pension funds are based in Anglo-Saxon countries) is that the former originates from civil law, while the latter has its base in common law. Nevertheless, industry funds in the Netherlands have a legal personality and should be operated separately from the employers' assets and solely for the interests of beneficiaries.

The current legislations allow both employees and employers jointly to set up an industry fund. Furthermore, if the social partners (i.e. representatives from employees and employers) agree, they could ask the Ministry of Social Affairs and Employment to impose an obligation on all employers and employees with their industries and require all of them to participate in this industry-wide fund. In this context, however, such a request to establish a compulsory industry fund has to be approved by the employer representatives who represent the interests of employers which employ at least 60% of the total workforce in that industry. There are no similar corresponding requirements on the employee representatives. Such compulsory participation, however, could be waived, if a particular company within the industry has already set up an individual pension fund, or when the performance of the industry fund is not satisfactory to meet the statutory requirements (i.e. matching of assets and liabilities). This system of compulsory participation is in line with the rulings of the European Court of Justice on the relation between competition law and labour law in connection with compulsory membership in a pension scheme.

Regarding the governance structure of the industry funds, there are three key components.

1) Management
This refers to executives or professional managers who manage the pension funds under supervision of the governing body, and they are mainly in charge of the day-to-day management of the industry funds. The current legislation requires that the funds should be in the hands of at least two persons.

Meanwhile, in order to ensure the smooth running of the pension funds, the management of the funds must prove to the satisfaction of the pension regulator (i.e. De Nederlandsche Bank) that at least two of its members possess specialist expertise, such as

- The governance of an organisation
- Legal and regulatory issues
- Financial investment and actuarial knowledge
- Accounting and auditing

2) Governing body
For this layer of the pension funds, stakeholders (i.e. plan members and employers) should be equally represented on the so-called governing board, and they are normally nominated and appointed by the relevant trade unions and industry associations. For example, for the

Pensioenfonds Horeca & Catering, the governing body has equal numbers of representatives from the employer organisation, i.e. Koninklijke Horeca Nederland and, the trade union organisations FNV Horecabond and CNV BedrijvenBond.

Due to concerns on conflict of interests, the following persons should not serve as members of the board of foundation:

- Employees of the pension funds
- Members and former members of the governing body and committees of the pension funds
- Advisors of the pension fund

Normally there is one chairperson on the board of foundation. However, the dual-chairperson system has been implemented in some Dutch industry funds. For example, the Pensioenfonds Horeca & Catering has two chairpersons; one (called employee chairperson) is appointed by and represents the employees and the other one (called employer chairperson) represents employers. The two chairpersons, however, rotate to chair the board on a yearly basis during the term. This is especially important, in that the chairperson has an extra vote in the event of a tied vote, but full consensus still remains the basic objective of any Dutch board of foundation.

3) Advisory board
It mainly advises the governing body or board of foundation on various issues (e.g. investment strategies) of the funds, either on a specific request from the board of foundation, or on their own accord. Regarding the member composition of the board, representatives from both employers and employees frequently sit on the board. This board serves the same purpose as the policy committees set up by the Australian master trusts.

4) Funding of defined benefit plans
Meanwhile, all funds in the Netherlands are subject to the financial supervisory requirements laid down in the Pension Act (which came into force on 1 January 2007) and the regulations based upon this act. Under the new requirements, pension funds will be required to achieve a coverage ratio (i.e., the ratio of the present value of assets over liabilities, based on marked-to-market calculations) implied by a 97½ percent probability of meeting their obligations. In cases where the indexation of benefits to inflation/wages is not guaranteed, this implies a coverage ratio, on average, of 130 percent, to be met within a period agreed on with the supervisor not exceeding 15 years (the required coverage ratio would be higher if funds provided guarantees). However, if the ratio falls below 105 percent, it has to be restored within a given time period (likely between one and three years, but this is being discussed in parliament), except at times of severe macroeconomic downturns or systematic risk.

4. Key characteristics

4.1 Equal representation

As described earlier, the governing body of the industry funds is required to have equal numbers of representatives from members and employers. Meanwhile, the policy of representation (although not necessarily equal representation) also applies to the advisory board. Another interesting observation is that for some industry funds, it is even possible that the board is chaired by two chairpersons, although they two fulfil this responsibility on a rotation basis.

4.2 Compulsory participation

Although it is not compulsory for a Dutch employer to have an occupational pension plan, for the industry funds, by relevant legislation, it is allowed for the government to make such participation compulsory if the employer representatives representing a significant proportion of the industry make such a request.

4.3 Large size of the industry fund industry

The size of the industry-wide pension funds in the Netherlands is large, in terms of both assets and the number of participants. It might be due to historical reasons of strong unionisation in the Netherlands, and the *de facto* compulsory participation in most industry-wide funds as noted above.

5. Main merits and weaknesses:

5.1. Merits

First, largely due to the common feature of mandatory participation, members within a particular industry could pool all their pension assets in a single fund, which then can achieve economies of scale. Indeed, the Stichting Pensioenfonds ABP is not only very large in the Netherlands, but it is also the largest pension fund in Europe, and one of the largest arguably in the world.

Second, like industry funds in other countries, equal representation of employee and employer representatives has been adopted in the Dutch industry fund industry. Meanwhile, the existence of dual chairperson mechanism which is innovative could serve as an extra layer protecting the interests of employees and employers.

5.2 Weaknesses

The main disadvantage of collective pension systems is the lack of individual choice and tailor-made solutions. But to the Dutch view these disadvantages are far outweighed by the advantages of collective arrangements.

6. Challenges:

The main “problem” of the Dutch industry-wide pension system is how to meet the challenges of ageing and transparency.

Annex A4. The United States

1. Overview of occupational pension markets in the United States

The system of occupational pension plans in the United States rests squarely on a foundation of tax considerations. In common with many other countries, the tax advantages can be substantial for both employers and employees. Indeed, it can be argued that these tax advantages are the primary reason for the existence of occupational retirement plans.

There is a distinction in the United States between a "qualified pension plan" under which systematic annuity payments are made to retired employees over a period of years (usually for life) and a "qualified defined contribution plan (other than a defined contribution pension plan)". The former can be either defined benefit (DB) or defined contribution (DC). The latter encompasses various profit-sharing, thrift and savings plans, where benefit distribution is normally in the form of a lump sum, and pre-retirement payments are sometimes possible (e.g. hardship).

Thus, complementary to Social Security (OASDI), there is a wide array of employment-related programs addressing retirement and long-term savings. The most important are:

- defined benefit (DB) pension plans, including cash balance plans;
- defined contribution (DC) pension plans;
- **multi-employer pension plans;**
- **simplified employee pension plans (SEPs) for small employers;**
- 401(k) plans, an important and US-specific variation of DC plans; B(k) plans, a recently introduced alternative that allows a DB pension plan and a 401(k) plan to operate as a single package;
- savings and thrift plans – now mostly replaced by 401(k) plans.
- employee stock ownership plans – a form of DC plan where the investments are primarily in employer stock;
- profit-sharing plans – a form of DC plan under which contributions are traditionally a function of company profits;
- stock bonus plans – under which contributions are made in the form of company stock; and
- tax-favored individual savings plans such as Individual Retirement Accounts (IRAs) operating under a employer-sponsored group arrangement. A "simplified employee pension plan" – see below – is a structured example of this approach.

The third and fourth categories are of greatest relevance to MOLSS and to its objective of encouraging the establishment and maintenance of Enterprise Annuities for SMEs. Each will be analyzed in turn.

2. Plan profile of the CPFs

2.1 Multi-employer (Taft Hartley) pension plans

A Taft-Hartley plan can be either a pension plan or a health benefit plan. The name "Taft-Hartley plan" is derived from the Taft-Hartley Act (also known as the Labor-Management Relations Act of 1947). The Taft-Hartley Act made it illegal for an employer to contribute to an employee benefit plan controlled by a union. As a result, all multi-employer plans must have equal number of representatives from management and labour. Other key features of the Taft-Hartley include:

- the fund receives contributions from more than one employer;
- the fund is established via collective bargaining between participating employers and unions;
- the fund is established under a trust, and must be exclusively for the benefits of employees;
- mobile employees moving within the industry do not need to change schemes as long as the existing and recipient employers participate in the same plan.

Given the above, it could be argued that the multi-employer plan (governed by the Taft-Hartley Act) is a pension arrangement between a labour union and a group of unrelated employers (usually in a common industry and region). It is the product of collective bargaining between organizations representing several employers and one or more unions. Most are defined benefit plans providing a flat dollar amount for each year of credited service. For example, a plan providing a benefit of $75 per month for each year of credited service would pay a pension of $2,250 per month from normal retirement age for a person with 30 years of credited service.

Currently, the arrangement has been popular in such industries where workers typically do not stay very long with the same employer. Examples include manufacturing industries (e.g. food and confectionary, printing and publishing, construction and furniture), and non-manufacturing industries (e.g. transport, wholesale and retail trades).

Almost 10 million employees are covered by multi-employer DB pension plans; 74% are in large plans with more than 10,000 participants. More than half of all such employees work in the construction and manufacturing sectors, where coverage under single employer plans is very poor. The services, retail trade and trucking sectors each account for another 14% of overall membership.

2.2 Simplified employee pension plans (SEPs) and SIMPLE IRAs

Under a SEP or SIMPLE IRA, employer contributions are directed to traditional individual retirement accounts called SEP-IRAs. Full-time, part-time and seasonal employees, self-employed persons, partners in partnerships, and sole proprietors – all can participate in SEPs. Companies, sole proprietors and partnerships can establish such plans. Employer contributions can vary from year-to-year, are tax deductible up to 25% of an employee’s salary, and are even eligible for a special tax credit for start-up costs.

Trustees are limited to banks, mutual funds, insurance companies that issue annuity contracts and other approved financial institutions. They receive and invest the contributions, administer the plan, make all relevant government filings and provide annual statements to each plan participant showing employer contributions and the current value of that person's SEP-IRA. As explained by the US Department of Labor: "A SEP does not have the start-up and operating costs of a conventional retirement plan" – particularly attractive features for SMEs.

3. Institutional Framework

3.1 Multi-employer (Taft Hartley) pension plans

Multi-employer plans are financed by participating employers through contributions generally specified in collective bargaining agreements. In this case, contributions are solely made by employers and employees normally do not need to contribute. Employer contributions are a tax-deductible business expense and do not create a taxable benefit-in-kind for the employees. These contributions are typically based on the number of hours worked by each employee covered by the plan. The employer contributions are typically fixed for the term of the collective arrangement between management and unions. However, employers may be required to make more contributions if the agreement specifies scheduled increases at pre-determined times, or terms ensuring maintenance of employees' benefit levels.

Therefore, in other words, the plan can give the appearance of being DC in terms of contributions going in, but is clearly DB in terms of benefits being paid out. This dilemma can aggravate the already complicated funding problems being experienced by multi-employer DB plans in the United States. Another serious concern is the effect on the funded status of the DB plan of the departure of one of the participating employers, whether voluntarily or through bankruptcy, since contributions of the remaining employers must provide for the benefits of the employees of a departing employer.

An individual plan participant who terminates service with one employer covered by the plan and joins another employer that also participates in the plan is not treated as a termination of employment. Instead, the individual continues to accrue retirement benefits. This portability feature makes multi-employer plans particularly attractive in such industries as construction, where employees constantly move from one construction site to another, and from one employer to another.

As noted earlier, the trustee structure features equal numbers of union and management representatives sitting on the board. The trustees are the decision makers of the operation of the fund, but they are not paid. The appointment and removal of trustees is normally specified in the fund agreement. In this context, trade unions (representing employees) have the power to appoint and remove the union trustees, while the employer associations (representing employers) have the same power and function with regard to employer trustees.

3.2 Simplified employee pension plans (SEPs) and SIMPLE IRAs

In reality, SEPs and SIMPLE IRAs are simply a collection of Individual Retirement Accounts (IRAs) that, in theory, anyone can buy on the street, or in other words, in the retail market. Therefore, they are operated in a framework much different from the multi-employer schemes as describe earlier. The operating structure is simple, in that there is only a single provider, i.e. professional financial institution or trustee. The providers are banks, mutual funds, insurance companies that issue annuity contracts and other eligible financial products, and they often provide "one-stop shopping", i.e. including asset management, trusteeship, etc., with the participants responsible for investment among the choices and for benefit payment decisions (including early withdrawal and lump sum payments).

Meanwhile, the above mentioned professional service providers are chosen by the plan sponsors, and individual employees cannot choose different providers, although each employee "owns" his or her IRA within the plan. Similar to the master trusts in other countries, employers play a "paternalistic" role in this case.

Regarding the governance structure of the pension funds, such pension assets could be managed either under trust or not. If under trust, there is no such requirement that employees and employers should be represented on the board of trustees. Therefore, if employer sponsors and/or employees are not satisfied with the professional trustee's performance, they may only consider replacing the trustee.

It has been argued that administrative costs of the SEPs and SIMPLE IRAs are low, given the fact that some regulatory requirements for standard occupational schemes are removed. For example, they are not required to file annual financial reports with the federal government. Meanwhile, the only real paper work between employers and the financial institution is a 2-page form, while all the other paper work and record keeping is conducted by the latter.

4. Key characteristics

4.1 Equal representation

For the multi-employer funds in the US, it is required to have equal numbers of employee (trade unions) and management (industry associations) representatives on the board of trustees.

4.2 Role of the private sector

The private sector has been playing a very important role in the occupational pension markets in general, and particularly the CPFs. For example, SMEs heavily rely on the private sector (e.g. insurance companies) to establish occupational pension schemes for their employees.

4.3 Tax concessions

The system of occupational pension plans in the United States rests squarely on a foundation of tax considerations, and the tax advantages can be substantial for both employers and employees. It can be said that most SMEs are driven by the tax incentives provided by the government that encourage the establishment and maintenance of occupational pension plans.

5. Merits and weaknesses:

5.1. Main merits

First, the mechanism of equal representation of interests of employees and employers has been set up in the US's multi-employer pension system, and it should protect interests of either party from being exploited by the other party.

Second, as in other countries, extensive participation of the private sector in the system facilitates SMEs to set up occupational pension plans, large due to economies of scale. Meanwhile, beneficiaries could benefit from professional services provided by financial institutions.

5.2 Main weaknesses

First, there is a potential risk of conflicts of interest in the existing pension system in the United States. Currently the legislation does not require the presence of independent directors on the board of trustees for the corporate trustee, as in Hong Kong, China, or the existence of policy committees as in Australia. As a result, it may be difficult to align their commercial interests with their fiduciary duties.

On the other hand, there has been no evidence of conflicts of interest occurring in US multiemployer plans since the enactment of reforms in 1974 that generally prohibited transactions with parties related to the plan. Note that risks in US multiemployer plans involving levels of cost should not arise for DC multiemployer plans.

Second, another point related to the above is the issue of cost. It is reported that some master trusts (such as insurance carriers) charge high costs due to their for-profit purpose, albeit some of the additional costs may be the result of greater investment choices and higher quality of service.

Third, there is some potential risk in the US retail plan market that individual participants will ultimately fail to have adequate savings due to the control participants have over such plans, including: decisions about how much to contribute out of their salary, investment choice decisions, and benefit payment elections (early withdrawal, failure to annuitize, etc.).

6. Challenges:

For multi-employer funds, the current system largely relates to such workers who typically stay over with the same employer. An important question is whether they should be open to the general public. For master trusts, their transparency of operations and risks related to participant control present challenges to be tackled.