

The winning strategy for the pension market in China



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Introduction

On March 6, 2019, in the Work Report at the Two Sessions, Premier Li Keqiang said: “The social security system and policy need to be further perfected, and a multilevel pension security system needs to be developed.” This remark has once again prompted Chinese society to reflect on elderly care and how China—a fast developing country—can address this issue. Which retirement types are most suitable for Chinese pensioners?

Traditional retirement models are being challenged as China accelerates towards an aging population with a low birthrate

Nations usually change into an aging society over a gradual and slow process. For example, it took France and Sweden 115 years and 85 years, respectively, to reach that stage. However, it has taken China only 25 years. In stark contrast, the decreasing birthrate in China hovered around 1.6 in 2018, much lower than the replacement ratio of 2.1. Due to the double trends of aging and low birthrate, it is expected that the elderly dependency ratio will fall from 9.9 (an average of 9.9 working people support 1.0 pensioner) in 2000 to 5.8 in 2020 and then to 2.3 in 2050. Therefore, the traditional family elderly-care models will not be sustainable.

China is developing a three-pillar pension system, but it is a long and problematic route

China’s three-pillar pension system started in 1991 and mainly relied on the first pillar of public pension. The country itself is responsible for the pension system, with an AUM of about RMB 4.4 trillion accounting for over 70 percent of the total amount. The second pillar is enterprise and occupational annuity. The enterprise annuity’s responsible owners are enterprises and their employees, and the occupational annuity is owned by the public sector and its staff. Their

total AUM is around RMB 1.6 trillion, making up the remaining 30 percent. The third pillar, the personal pension, is still at a nascent stage and currently has no unified definition and scope. The first pillar’s overall volume and amount have continued to rise, but the income replacement ratio (defined as the ratio of the pension one receives upon retirement to the income received before retirement) remains less than 50 percent. Moreover, the government’s burden continues to be a challenge, as it is faced with slowing revenue, growing expenses, and complete depletion of funds in some areas. The financial subsidy for the first pillar is increasing year by year, though this will be hard to sustain in the long run. The commercial reform of China’s pension system is imminent, and the second and third pillars are in urgent need of a balanced development.

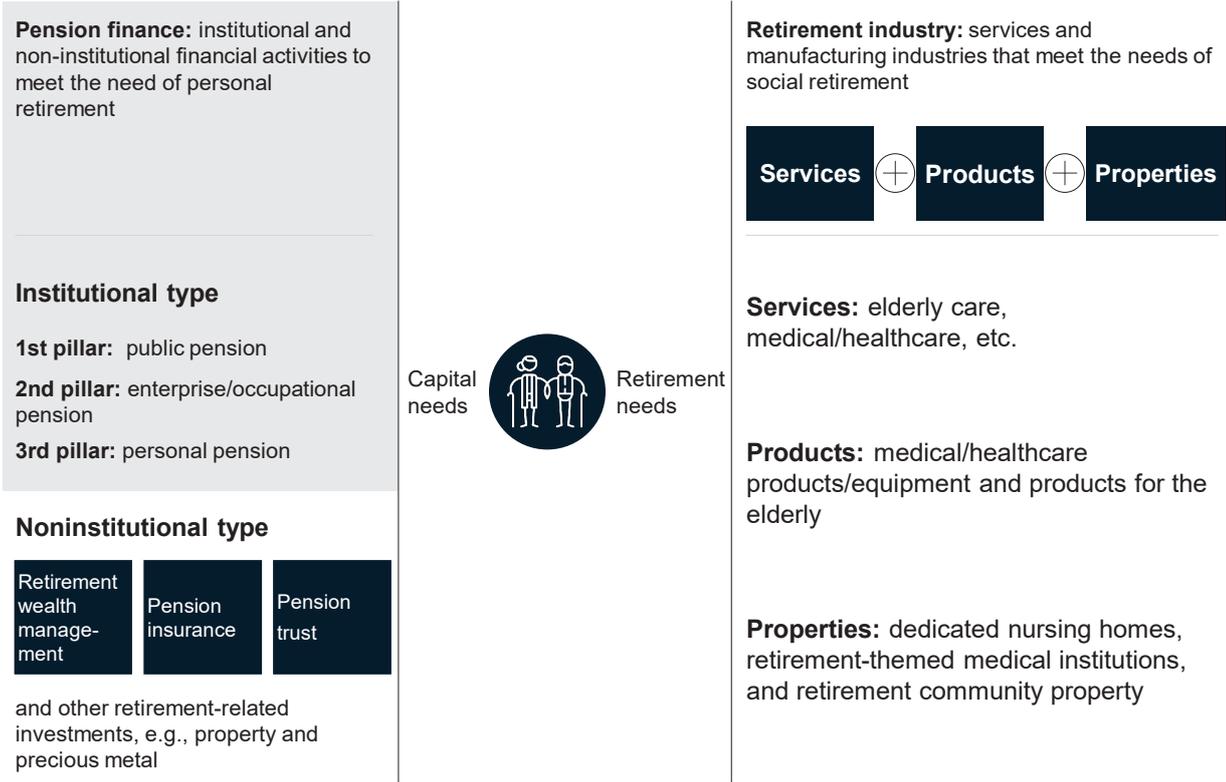
It’s inevitable that the gap must be closed quickly and the second and third pillar of the commercial pension developed

China’s retirement system should be composed of the pension finance and retirement sector (Exhibit 1). Pension finance refers to financial activities to meet an individual’s retirement life needs, while the retirement sector refers to the related services, products, and property industries to meet social retirement needs.

There are two types of pension finance: institutional and noninstitutional. According to industry consensus, the institutional type has four main characteristics: a unique and dedicated retirement account, the account is always locked except for withdrawal upon retirement, the account is entitled to tax preferential policies, and pension investment is subject to special regulation. For historical reasons, China’s development of the commercial pension is relatively behind, and the first third-pillar product—the personal tax-deferred pension insurance—was only launched in the middle of 2018.

Exhibit 1: Overview of the retirement finance industry and value chain

■ Focus of this paper



Under the current circumstances in China, McKinsey believes that a commercial pension system mainly supported by the second and third pillars has more advantages: (1) it will be a strong complement to the public pension; (2) it will provide more diverse and customized retirement financial plans for consumers and their enterprises; (3) it will enable investing in more asset classes to further promote China's capital market development. In addition, the pension system's commercialization reform can also help foster a stable pension system in the nation by

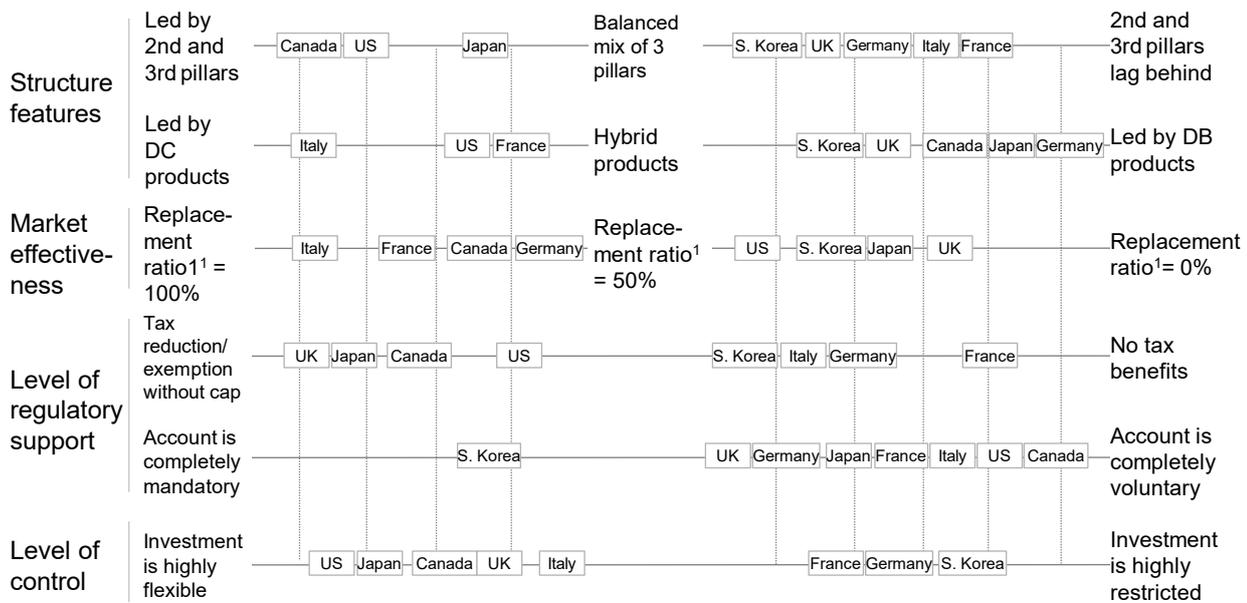
clarifying ownership among the state, enterprises, and individuals. Especially over the past two years, the development of the commercial pension sector has gained traction due to the top-level design from the government authorities, broad participation from enterprises, and elevated awareness from the public.

This white paper focuses on China's institutional pension system, especially the development of the second and third pillars. We sincerely hope this publication will offer insights on the development of participants in China's pension market.



Chapter 1: An overview of the global pension system

Exhibit 2: Pension systems differ, mostly in market activities and levels of regulatory support and government control



¹ Net replacement ratio: calculated by the net amount of pension received by individuals, divided by the net amount of income before retirement, while considering the personal income tax and social security paid by pensioners. This indicator is used to measure the effectiveness of the amount of pension received under the pension system to replace pre-retirement income; here we use the male net replacement published by the OECD

Source: OECD; expert interview; McKinsey Global Insurance database; McKinsey analysis

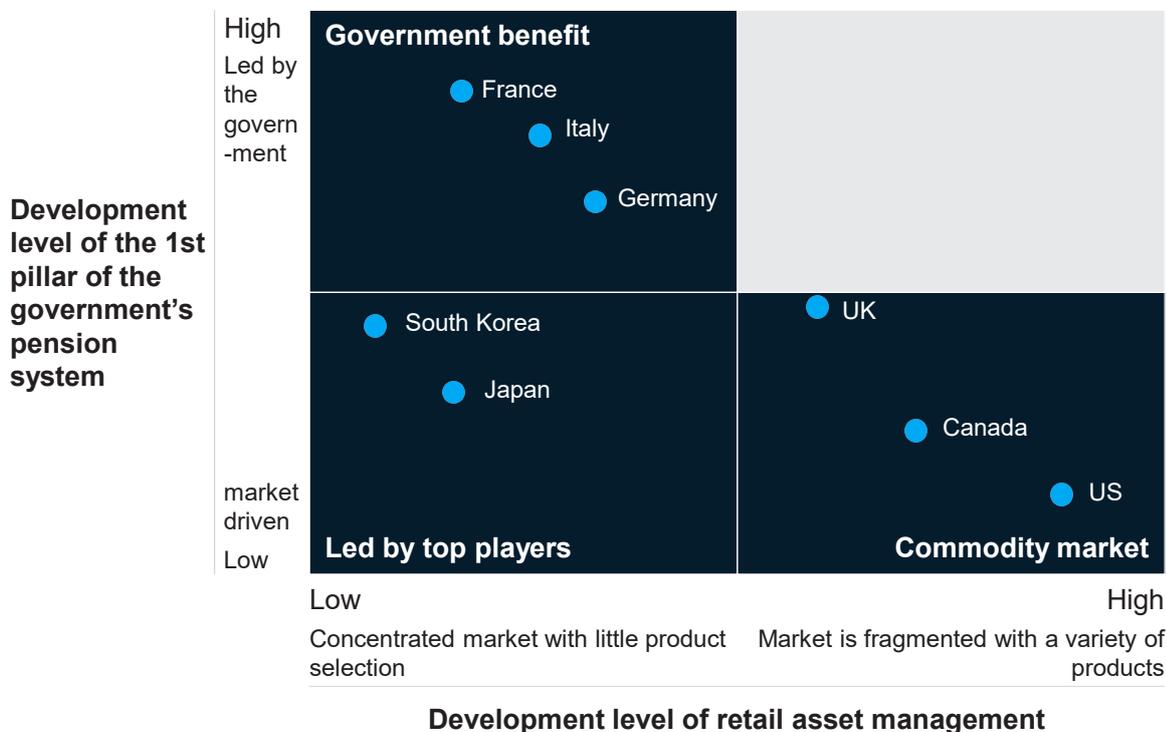
In the global market and in light of different development paths and stages and retirement mindsets, countries show significant differences in terms of pension structure, market efficiency, level of policy support and governance (Exhibit 2).

McKinsey evaluates each country's pension system along two dimensions: (1) the mix of pension structure: a higher proportion of the first pillar indicates the government's take on bigger responsibilities in the pension system, thus private retirement savings by the business and consumers is a lower responsibility and has less potential in the market. (2) The maturity of financial markets, especially the retail asset management market: the maturity of the market decides commercial pension products' type and variety of providers. Based on these two

dimensions, we believe that the pension market in advanced markets demonstrates three types: government-benefit type, commodity market type, and multimopoly type (Exhibit 3). Developing countries, including China, will evolve into one of these models as their economy grows and their pension system matures.

1. **Commodity market type.** In mature markets, such as the United States and Canada, pension systems are completely market driven after almost a century of development. The government's role in the first pillar is very low (e.g., 10 percent in the United States), while their retail asset management is highly advanced. Consumers have been fully educated by the capital market on where they can find a variety of easy-to-buy pension products to

Exhibit 3: The global pension insurance market can be divided into 3 types



- meet their needs, including low-cost ETF (exchange-traded funds) and TDF (target-date funds), among others. Retail asset managers, led by fund companies like Fidelity and Vanguard, are the key market players.
- 2. Government benefit type.** European countries like Germany and France provide good benefits. The first pillar accounts for a large share in their pension system (e.g., 69 percent in Germany). Meanwhile, the growth of the second and third pillar has flattened at a large scale. Since their retail asset management industry is less mature than the United States and UK, insurers are the key players, with much less competition from fund companies.
 - 3. Lead by top players type.** In this kind of market, as represented by Japan and South Korea, three pillars are evenly distributed. Unlike the commodity market type, Japan's and South Korea's capital and asset management market is less developed, and their consumers highly value brand but know less about pension and investment products. As a result, the markets are dominated by big insurers and banks.

Each country's pension system development has its own special circumstances and history; therefore, there is not a single correct and ideal model. We think the United States, Germany, and South Korea are typical examples of each model, providing a reference framework for Chinese regulators and pension companies.

The United States: highly advanced capital market led by fund companies

Tax incentive policies enable the fast development of the second and third pillars

After a century's development, the US pension system is dominated by the second and third pillars due to various government incentive policies. The 401(k) plan in the second pillar, the most important employee retirement plan for private companies, is a corporate supplementary retirement insurance plan jointly contributed to by employers and employees. The IRA in the third pillar, an investment pension account voluntarily contributed to by individuals, has become a pension product on par with the 401(k) in the US private pension market. In the past decades, the US government improved policies and regulations, introduced tax-deferred incentive policies, and kept raising exemption amounts. Meanwhile, it also added automatic joint clauses and improve accounts' transferability, by allowing a free transfer of capital among accounts. So far, the second and third pillars' individual commercial pension capital has accounted for 90 percent of the total pension asset.

A mature capital market enables fund-type asset managers to lead the market

Individuals have the freedom to select products,

whether they choose a 401(k) or IRA. As the US capital market gradually matures, fund-type asset managers have used their rich product mix, professional investment management, and bull markets to generate high returns on investment, thereby successfully overtaking banks and insurers to become the leader in the second and third pillar pension markets in the United States. For example, asset management products' proportion in the IRA plan has significantly risen in the past 40 years. As of 2017, it accounted for 65 percent in the total assets of the IRA plan (Exhibit 4). Blackrock, Fidelity, and Vanguard are the major providers in the common fund products, contributing over 40 percent¹ to market share by AUM.

Germany: national public pension dominates, while commercial pension is catching up

Overburdened public finance is prompting pension responsibilities to move toward the private sector

Germany is the first country in the world that established a social security system. As one of its key components, the pension system boasts a history of 120 years. The German government leads and pursues a long-term pension system of "receive/pay on the go." However, due to a slowing economy, accelerated aging phenom-

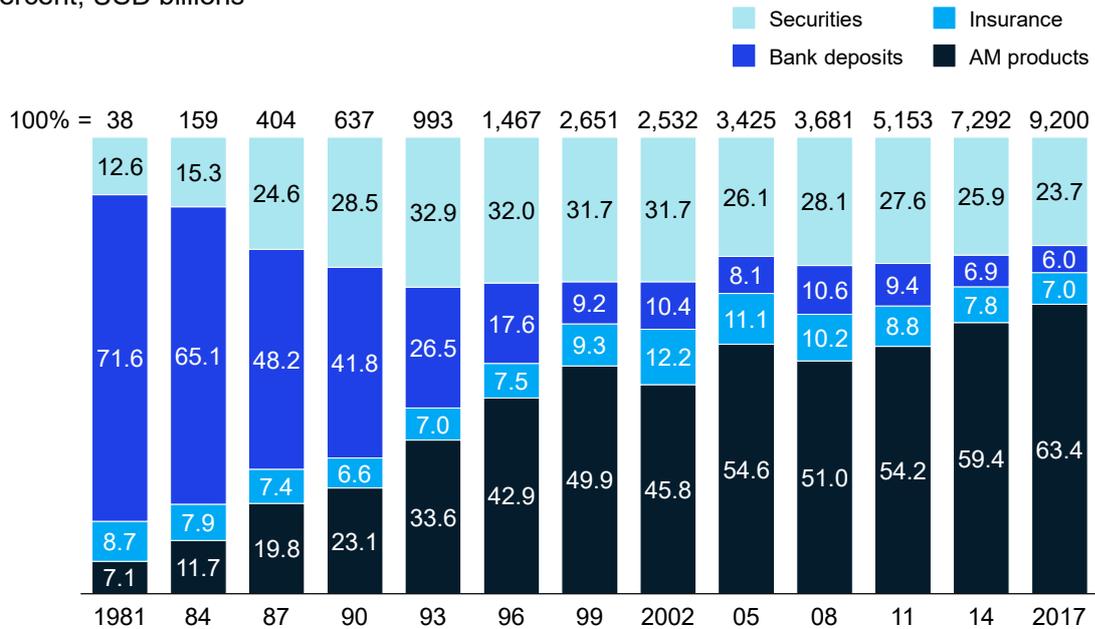
¹ McKinsey US Wealth and Asset Management Practice estimate.

Tax incentive policies enabled fast development of the 401(k) plan and IRA in the United States, the commercial pension capital has accounted for 90 percent of the total pension market.

Fund-type asset managers become leaders in the second and third pillar pension markets in the United States using a rich product mix and professional investment management skills.

Exhibit 4: Asset managers become the most important provider of investment products under the 3rd pillar of the IRA plan in the US

Proportion of each kind of investment product under the IRA plan
Percent, USD billions



Source: US Federal Reserve, "Financial Accounts of the United States" table 227

enon, and increasing social dependency ratio, its government pension gap is widening year by year. Unable to absorb this burden, the government started to actively promote reforms in the pension system at the start of the 21st century by encouraging more pension responsibilities to transfer from the public to the private sector. For example, it introduced the BRSG to enable annuity for low-income people through raising the tax-deduction cap and offering employers subsidies. The government also introduced pure DC products to foster the development of the second pillar enterprise annuity. In addition, the German government also launched the Riester Reform to expand the pension scope to insurance, fund, and savings products, so as to encourage insurers, banks, and fund companies to provide pension products.

Insurer giants dominate the commercial insurance sector

The German public is risk averse and conservative in investment philosophy. Compared with the

United States and UK, the retail asset management sector in Germany is not active. Although the government encourages more financial institutions to participate in the commercial pension business, insurance types of financial organizations remain the key players in the enterprise annuity and individual commercial pension market. The top five insurers account for more than half of the market (Exhibit 5). Due to its reputation, brand, digital transformation, and customer-centric product/service strategy, Allianz attracts many German consumers. Its premium scale and growth far outstrip other peers.

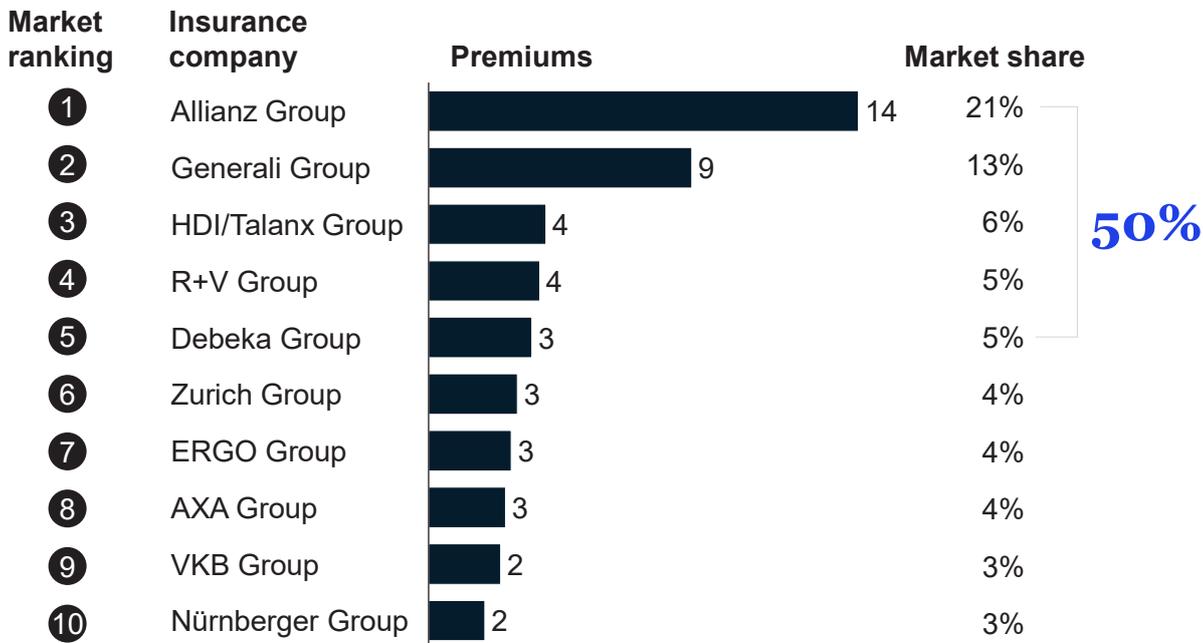
South Korea: late but fast mover; banks and insurers gain advantages

Profound reforms enabled the rapid development of three pillars

In the 1960s, South Korea set out to develop its multitier, three-pillar pension system with comprehensive coverage. The system is less than perfect and still improving. Currently, the

Exhibit 5: Proportion of insurers' income in the 3rd pillar in Germany in 2017

EUR billions
Estimates



Note: Calculation method: insurers' 3rd pillar premiums = total premiums – group premiums
Source: McKinsey's Germany Insurance database

government-led first pillar remains a major force, and its asset size accounts for over 50 percent. However, the public pension's replacement ratio is less than 40 percent, and the whole system faces huge challenges. In 2001, the government revised individual retirement plans and forced the reform of enterprise annuity by introducing the IRP account. As a result, the second and third pillars have grown fast in the past decade. As of now, the third pillar's personal commercial pension insurance asset accounts for over 30 percent of total pension assets. The mix of three pillars is becoming more balanced.

Large banks and insurer giants dominate the second and third pillars, respectively

South Korea adopted an access-approval system for pension companies and places many restrictions on pension investment. Currently, its enterprise annuity and commercial pension insurance market is comprised mainly of reputable insurers and banks. Banks account for 51 percent of total annuity business in the second

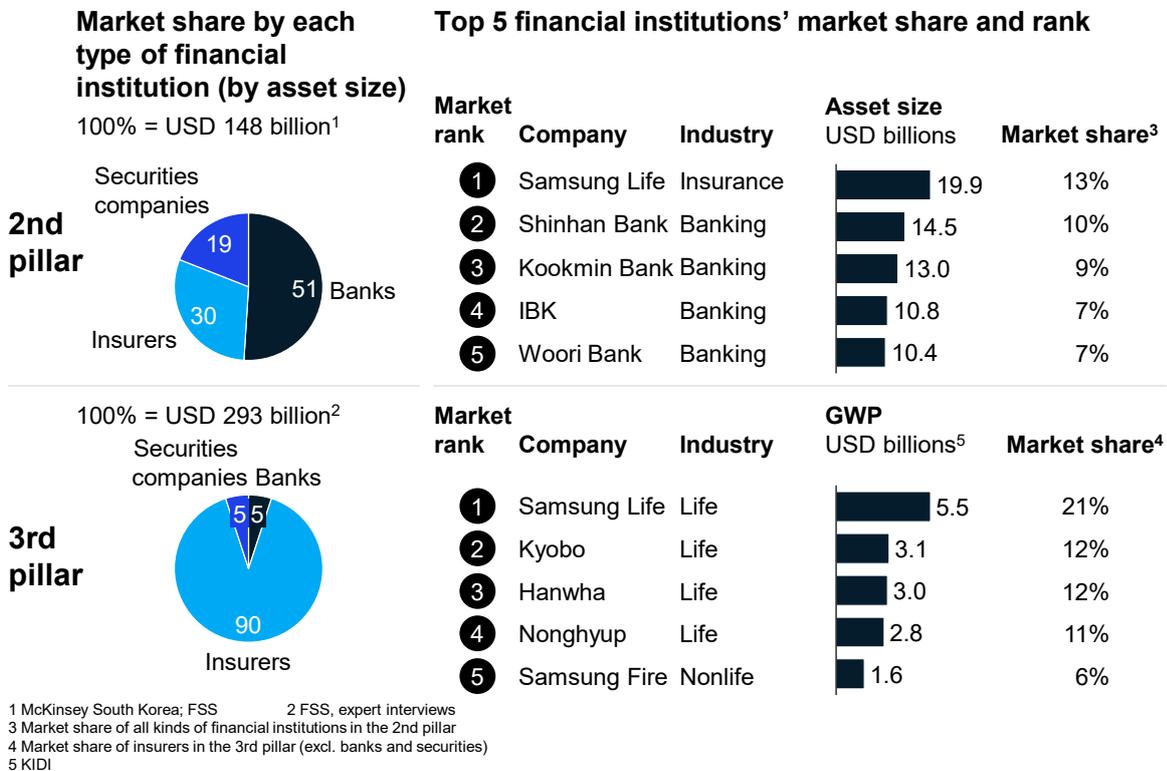
pillar, while insurers make up 90 percent of the total personal commercial pension market in the third pillar (Exhibit 6). Influenced by low interest rates, the public hopes to get a higher return on investment for pension products. With incentive policies from the government, asset managers well versed in investment management are playing more important roles and starting to challenge the leading positions of insurers and banks.

When we compare each nation's pension system development, there is no single ideal model. China is at the crossroads of pension reform. Based on China's circumstances and global market development trends, McKinsey offers the following observations on China's pension market:

- **Unbalanced development of the pension system with commercial pensions in urgent need of development**

The unbalanced development of the three pillars cannot continue in the long run. The first and second pillars need immediate re-

Exhibit 6: Market shares in South Korea's 2nd and 3rd pillars in 2017



form, mainly due to the guidance and incentive of government policies. Our regulators can learn from the experience and lessons of each country's pension account, product tools, investment management, and tax incentives.

- **Lack of pension products, leaving bright future for product innovation**
China's commercial pension market just got started with very limited product selections. Due to consumers' strong and diverse needs along with policy liberalization, there is a huge space for innovation in third-pillar products. There is also a great deal of potential in quickly identifying and responding to consumers' personalized needs.
- **Insurance giants enjoy huge advantages and should shoulder more social responsibilities**
With their brand image, a natural fit between insurance products and retirement, as well as experience in managing insurance

assets, insurer giants such as Allianz enjoy huge advantages in the pension finance market. They have also assumed more social responsibilities in participating in the development of the personal pension market and investor education.

- **Unbalanced regional development and advanced regions are expected to enter the US-style industry landscape**
As China has a huge population and regional economic development is unbalanced, the reform of the commercial pension market cannot be achieved at once. Developed areas like large bay areas and the Yangtze Delta Region enjoy obvious advantages in terms of capital market maturity, residents' income level, and consumption demand. Therefore, in these economically advanced areas, flexible and professional fund companies will also play important roles. Asset and wealth managers like Fidelity can provide good lessons for their Chinese counterparts.

Ontario Teachers' Pension Plan's (OTPP)

Ben Chan on secrets to investment success



Ben Chan

— OTTP Asia Regional Managing Director

OTPP is one of the most respected, specialized, and professional pensions in Canada. What do you think is the secret of OTTP's success?

To talk about OTTP's achievements today, you must look at its history. Prior to the establishment of OTTP in 1990, pensions for teachers in Ontario were fully supported by the government. Teachers received pensions in amounts linked to their preretirement income (a typical defined benefit scheme), and funds were invested mainly in local government bonds. However, the fund was in a state of deficit and had to be bailed out by the government.

Since then, we've made huge improvements. In April 2018, our net assets reached CAD 189.5 billion, and based on conservative actuarial assumptions the pension's overall profit stood at 105 percent. In 2017, we achieved a net investment income of CAD 17.0 billion with an investment return of 9.7 percent for that year.

This improvement is primarily due to profound reforms of the pension governance system in 1990. OTTP was set up as an independent and professional investment institution responsible for the pensions of public-school teachers of Ontario. The whole setup is similar to a general manager system authorized by a board of directors in the private sector. Government and teacher representatives sit on our board, but

they don't participate deeply with the day-to-day operation of the fund. The professional staff of OTTP are focused on maximizing the return on investment while ensuring appropriate liquidity. The Teachers' Pension Act and other legislation ensure that such arrangements are not destabilized by changes in the government.

Today, the OTTP investment team's goal is to achieve an "inflation + 4 percent" return on investment on a sustained basis. It is not easy to achieve this goal year after year. As such, we have found the best investment talent in the industry. Regardless of educational background and personal vision, our employees always take OTTP's goal to heart.

The return on investment of OTTP has not only met the "inflation + 4 percent" target but has also exceeded it in many years. Can you share the principles and rationale of your investment strategy?

We have three primary principles that guide our investment strategy. The first principle is to insist on in-house investment management. We manage 80 percent of our own portfolio, with only 20 percent being handed over to other asset managers. This principle is based on several considerations. The first is our objective of building the capabilities of our in-house team, because we believe that our own investment team is the most aligned with OTTP in values and mind-set.

Next, an in-house team is more stable, and the portfolio and intent of the investment are more transparent. Therefore, the core management team knows the current state of our investments and the goals behind them. And finally, in-house teams have a long-term cost advantage over external managers. This cost advantage has become increasingly obvious as our total assets under management has exceeded CAD 180 billion. While we are proud of our in-house team, we also strongly believe in complementing their efforts with the most appropriate partners in different investment areas. Combining the knowledge and experience accumulated by our long-term investment funds and partners helps to achieve a win-win investment strategy.

The second principle is a focus on long-term investments. The professional investment sector is generally affected by short-term volatility, including public, private, and hedge funds, which are forced to make investment decisions due to pressure on annual and even quarterly results. But we don't have to. Pensions are well suited for long-term investment, and OTPP outperforms many other investors (insurance companies, public equity funds, and private equity funds) in debt duration, which is to our advantage. We're not pressured by short-term return expectations. We can configure more asset classes with better risk benefits over the long term. For example, we invest in a lot of PE projects in Canada, usually with long lock periods. We have real-estate and infrastructure investments around the world, which are not only priority projects for many local governments but often have good long-term returns.

The third principle is diversification of our investments. We diversify not just to spread out our

risk across asset classes, it's also a philosophy of investment. We cover all investment categories—including equity (secondary market and PE), fixed income, credit assets, and real estate. From a geographical perspective, we have traditionally been active in North America, but as emerging markets (particularly Asia) build up their investment capabilities, our share of investment there has risen every year. To this end, we follow a rigorous, top-down set of asset allocation logic, for which our global chief investment officer is usually directly responsible.

China is carrying out a series of pension reforms. From your experience in OTPP, what are your thoughts and suggestions on China's pension reforms?

I am not an expert on China's pension policy, so I will share OTPP's experience. We believe that professional investment teams should be given authority in top-level design of pension systems. To empower our professional team, we give them clear investment goals and mandates, which should be challenging but practical. Another priority is to pay attention to talent, which at OTPP is very market oriented. We offer competitive, market-based compensation to recruit the best people.

Finally, it's important to consider risk management and corporate social responsibility. Of course, we face both macro and micro investment risks. We have rigorous processes and standards to control such risks. The most important risk to consider, however, is reputational. We only invest in socially responsible industries and businesses and won't touch industries with high returns but poor social reputations, such as tobacco. This is both our investment policy and our corporate mission.

Pensions are well-suited for long-term investment, and OTPP outperforms many other investors in debt duration, which is to our advantage. We're not pressured by short-term return expectations.



Chapter 2: An outlook of China's commercial pension market

The overall second pillar's annuity market enjoys a stable development

Enterprise annuity customers are mainly large companies and this won't change in the short term

After 14 years of development, China's current enterprise annuity size stands at about RMB 1.2 trillion, accounting for 1.6 percent of its GDP. It is, however, still well below the level of developed countries like the United States (27.3 percent) and Australia (>100 percent). Furthermore, the coverage of annuity among Chinese enterprises is relatively low, with about 20 million employees participating in annuity plans. The participants are mainly SOEs whose workforce account for only less than 5 percent in the total working population in cities and towns across the country. In addition, their growth has stagnated. Private enterprises' coverage is very low due to their rising operational costs. Many of them, especially SMEs, have not yet paid the basic social security for their employees, let alone annuities. The Management Guideline of Enterprise Annuity, introduced in 2018, encouraged enterprises to establish annuity systems and increase long-term incentives for key talents. However, as the global economy slows, the government is now trying to support the private sector by further reducing their burden. The Ministry of Finance said that it would further dial down the social security contribution ratio start-

ing from May 1, 2019. Therefore, it is unlikely that private enterprises shall be obliged to establish annuity plans, and their annuity market will not experience explosive growth.

Occupational annuity enjoys stable growth with limited potential

The Occupational Annuity Guideline in 2015 essentially changed the former DB pension scheme of the government authorities and institutions to the DC pension scheme. It replaced MOF's sole financial responsibility with MOF plus the market so as to mitigate financial risks. Unlike enterprise annuities, which have a coverage issue, occupational annuities are mandatory and thus their market size is clear and predictable. Currently, its main growth lever is accumulated payments, which are expected to experience stable growth in the following years. However, its potential is limited and will gradually enter a stage of balanced payments and withdrawals.

Limited profit for annuity management and investment, B2C cross-sales can be used to realize value

Currently, annuity management and investment are regulated via strict license approvals. Market players cannot expect to reap extra investment returns, and each has some slight differences. Annuity products are rather undifferentiated in features and the employee participation ratio is relatively low. Currently, overall profitability of

Restricted by economic affordability, private enterprises especially SMEs have less chance to join the enterprise annuity scheme, hence will not drive explosive growth in the annuity market.

the annuity business is low, and its competition mainly focuses on price, investment returns, and sales relationships. In the middle to long run, however, annuity can be a hook product for insurers and banks to build a long-term relationship and explore other businesses with medium and large enterprises that have a large number of workforce with stable income.

The third pillar of personal commercial pension has “explosive” growth potential

An alarming gap in social retirement savings, and huge demands for third pillar's basic needs

The first pillar public pension's replacement ratio is less than 50 percent, and monthly pensions payment in cities and towns are about RMB 3,000. The coverage of the second pillar of occupational/enterprise annuity is very low, with most uncovered by annuity and suffering from a huge gap in retirement savings. Most non-institutional pension products, like commercial pension insurance and retirement investment products are very much undifferentiated and unsupported by tax benefit policies. Compared with traditional investment products and real estate investment, their return are less competitive and cannot meet the retirement financial needs of the middle class and HNW segments.

Individual retirement needs are becoming more diverse, resulting in more comprehensive commercial retirement products

With China's fast-growing economy, development of medical technologies, and longer average life expectancy, the first generation of the middle class (mainly post-70s/80s) are expecting more from their retirement life. The requirements of wealth management, pension management, and health management have converged and become more diverse and complex. Compared with the institutional and standardized first and second pillars, the third pillar enjoys a unique advantage in quickly identifying and responding in a timely fashion to consumers'

personalized needs.

Preferential policies spurred the rapid development of China's personal pension business

On May 2018, the pilot of personal income-tax-deferred pension insurance heralded the third pillar. The income tax reform in the same year expanded the tax base from compensation to comprehensive incomes and called out the support areas of education and retirement. This provided the policy support for capital, which was invested in financial products and real estate, to switch to the pension investment. In October 2018, Guo Shuqing, Head of CBRC, stated at the IOPS's annual meeting: “China will further reform and promote the supply-side structural reform in the pension market, with a focus to improve the replacement ratio in the second and third pillar and to promote the commercial pension insurance to provide more effective long-term capital for the economic development.” 2018 was a milestone in the development of China's pension business, witnessing the introduction of multiple policies and pilots that laid a solid foundation for the long-term healthy growth of the third pillar.

Public policies set the direction for the personal pension industry

Based on the global experience in pension development, regulatory policy guidance and support are core drivers of explosive growth in the market. McKinsey believes that China needs to fully learn from global experience while considering its own specific circumstances so as to continue optimizing regulatory systems and supporting the rapid and healthy development of personal pension businesses in the following three areas:

Enhance system design

The current pension system is lacking a unified top-level design, with CBRC and CSRC pushing pilots via different product types in each industry. Furthermore, the account system is yet to be linked with the information platform, and a unified tax incentive policy has yet to be

Foreign insurers have entered China's pension market, bringing leading global experience and concepts that will benefit the industry's healthy and diversified growth.

launched. In addition, the current pension regulatory mechanism is not clear, with professional supervision from the Ministry of Human Affairs and financial supervision from CBRC. It is suggested the governance body and mechanism for the pension be articulated and professional organizations be engaged for its top-level design to ensure the policy is consistent and cohesive. Using the top-level design, the following should be introduced as soon as possible: a reliable and unified pension account, management platforms, tax incentive policies, and investment guidelines aligned with the pension industry, so as to regulate the industry development.

Guide an open innovation

Currently, the pension pilot scheme has exposed a series of issues like limited tax incentives, a narrow product scope, and complex policy purchase and tax redemption. It is recommended that more companies be allowed to participate, the pension policy restrictions be lifted reasonably, the tax incentive ratio raised, and the investment scope and volume cap extended so as to create a sound policy environment for innovation.

Strictly safeguard baselines from risks

With consumers' long-term pension security and legal rights as a starting point, we should establish a sound risk prevention and control system, strengthen process supervision and monitoring, and severely penalize incompliances. Meanwhile, we should also improve the systematic risk pre-warning and management mechanism to guard against systemic risks related to longevity and investment.

Foreign insurers have entered the market to support the fast development of China's third pillar personal pension market

On March 27, 2019, CBRC announced that it had approved Heng An Standard Retirement Insurance Co., Ltd to establish the first foreign pension insurance company in China, signaling the official entry of foreign insurers into the pension insurance market.

Foreign insurers are confident in the Chinese pension insurance market's potential

Due to the policy incentives in 2018 and uncovering the middle class's retirement needs, foreign pension financial companies are confident in China's pension market. The market has just opened, so it is still small and has weak competition. It is the best time to enter this market. Additionally, the middle to high earners in tier one and two cities are the first group of core users of personal pensions, and they prefer foreign brands.

Their leading concepts and investment management experience will help China's pension market grow faster

Foreign leading pension companies have accumulated profound experience in product design, customer service, and investment management over a long period in the past. On one hand, they will bring richer pension products and consumer selections to promote the industry's innovation. On the other hand, as professional long-term institutional investors, foreign pension companies can help China's capital market grow stably in the long run.

Developing China's pension system: An interview with Professor Keyong Dong

Professor Keyong Dong

- Professor at the Renmin University of China (RUC), Ph.D. in Economics, Ph.D. tutor
- Director of the Research Center for Retirement Finance, Renmin University of China (RUC)
- Secretary-General of CAFF 50 (China Aging Finance Forum)



How will China's pension system develop in the future? What are your suggestions on the reform of the pension system?

As China's population ages, the pension system is now in the spotlight. After several decades of development, China has established a complex, three-pillar pension system with wide coverage and multiparty participation. Despite remarkable achievements, the system faces many challenges—chief among them the fragmented nature of the system's structure. Currently, the first pillar—the public pension system, which is split into urban and a rural components and is funded by employers through a pay-as-you-go scheme and employees via individual accounts—is the most developed and serves most workers in China. The second pillar offers voluntary enterprise annuities to employees of state-owned enterprises as well as voluntary occupational annuities to government employees. The third pillar is still nascent but in theory offers a path for supplementary private retirement savings with government tax benefits—akin to individual retirement accounts in the United States. The first pillar is currently dominant, while the other two have developed slowly and are currently insufficient. The experience of developed countries shows that only a multipillar mix of pension systems and options will enable the sharing of retirement-savings responsibilities of governments, enterprises, and individuals. In this way, we can better spread risks and promote the sustainability of

the pension system to address the challenges of an aging population.

I think we need to reform each of the three pillars in distinct ways. First, we need to consolidate the first pillar and standardize its payment models. The urban and rural components should be united into one national public pension. We should then build a transparent payment scheme by standardizing all components of the system, including the base and ratio of payment from employers and employees, methods of salary calculation and adjustment, and fund management. To improve the sustainability of the system, we need to study the incentives and approaches for deferred retirement.

Second, we need to promote the development of the second pillar by doing several things, starting with strengthening tax incentives for participation. We should also consider automatically enrolling eligible employees, as opposed to making them opt in; rectify the unfunded accounts of some occupational annuities; and achieve real account management as soon as possible. Meanwhile, we should also improve the investment management mechanism and introduce the "personal investment choices", e.g. an employee has choices in the underlying pension investments in his/her second pillar accounts, at the right time. When the time is right, we should also consider consolidating the enterprise annuity with the occupational annuity to form a

unified second pillar.

Third, we need to speed up the development of the third pillar. At present, the third pillar of China's pension system is still in the pilot phase. We should use that pilot experience to guide policy making to strengthen fiscal and tax policies that will facilitate expansion and maturation of private pension products, optimize the process of individual participation, and set up a complete personal pension scheme as soon as possible.

The third pillar of personal pensions is currently nascent. What are your suggestions for its system design?

The system design of the third pillar can be approached in the following ways. First, we need to expand access to the system to the entire Chinese workforce. In my view, the third pillar is a supplement to the public pension scheme to cope with an aging population and improve the pension system. This platform should be open to individuals, governments, and enterprises. The relevant departments should fully discuss the platform development to optimize the individual participation process and facilitate system supervision.

Second, as I mentioned earlier, we need to set up fiscal and tax policies to facilitate the expansion of both the second and the third pillars. Such policies will be the core driving force for developing the second and third pillars. Apart from the EET model, we can also explore the EEE model—that is, include personal pensions as additional special deductions under the Individual Income Tax Law. Fiscal subsidies can be offered to low- and middle-income groups.

Third, we need to drastically increase the number of personal pension products available. Today, just a few financial institutions provide individual pension products. To meet the diversified product needs of the participants, a much larger set of financial institutions, such as banks, funds, and insurers, should study the market and begin offering a diverse set of products that meets the different needs and experiences of citizens. They should follow the principle of providing long-term and convenient service for participants to design the pension financial products and fully leverage the advantages of

the financial institutions in risk guarantee and investment management.

Finally, we need to establish proper supervision of the third-pillar system. This monitoring will involve several sectors and agencies, so mutual cooperation, good interaction, and smooth communication among regulatory authorities will be an important foundation for the healthy and rapid development of the personal pension system. In the near term, the number of participating financial institutions should be carefully expanded and the regulation model tested before scaling out to all corners of the market in the future.

The third pillar of personal pensions is a new concept for Chinese people. How should we promote pension finance education for them?

It is very important to improve people's retirement-related financial knowledge through systemic, diversified educational methods involving multiple parties and following relevant laws and regulations. To promote and implement pension finance education, it's necessary to coordinate all kinds of resources and carry out a comprehensive evaluation. Specific considerations may be considered in the following areas.

First, we should take full advantage of the government's general guidance role. In general, financial activities are proactive actions taken by participants. However, many pension investors are mainly attracted by tax benefits and are passively engaged in pension investment without financial knowledge. Therefore, the pension finance education is, to a certain extent, universally needed as a public welfare. It's necessary for the government to guide all sectors of the society to establish a pension finance education system. The first action is to include pension finance in the national education agenda for preparation of an aging society. In 2018, the National Office of an Aging Society, the Ministry of Central Publicity, and the Ministry of Central Organization jointly issued the Notice on Carrying out the Education of an Aging Society, which is the first time China has promoted aging education at the government level. Including pension financial education in that initiative will go far in promoting national awareness. The second action is to design the framework of the pension

finance education system, set guidance for cooperation across all financial sectors, and ensure systematic development going forward. The third action is to make sure necessary financial support is in place, for example, by setting up a special fund for the education efforts to encourage involvement from more social institutions.

Second, we should take full advantage of market forces. The first action is to reiterate the crucial role of financial institutions such as insurers, banks, and funds in individuals' pension finance education. These organizations have a wide range of customers, and this makes them important channels to roll out financial education for the elderly as well as the general population. Financial institutions should integrate the concept of pension finance education into the design, investment, information disclosure, and post-investment management of pension products. They should also provide customized consultation and guidance according to investors' risk preferences and return characteristics and set up an education scheme tailored to different customers and products. The second action is to strongly support the development of the third-party investment and consultancy institutions related to pension finance educa-

tion. Professional investment consultancies can formulate and refine educational programs with different features according to different ages, cultural backgrounds, and asset statuses of customers to meet the diversified needs of financial education.

When it comes to financial education for the elderly in particular, all parties should pay attention to both the development of investment ability and mitigation of fraud risk. In recent years, there have been frequent reports of criminals taking advantage of middle-aged and elderly people's lack of financial knowledge to perpetrate financial fraud using pension products as bait. This illegal behavior has affected the healthy and legal development of pension system, as well as the population's trust in it. We need to ensure our citizens are investing in proper pension products through legitimate investment channels.

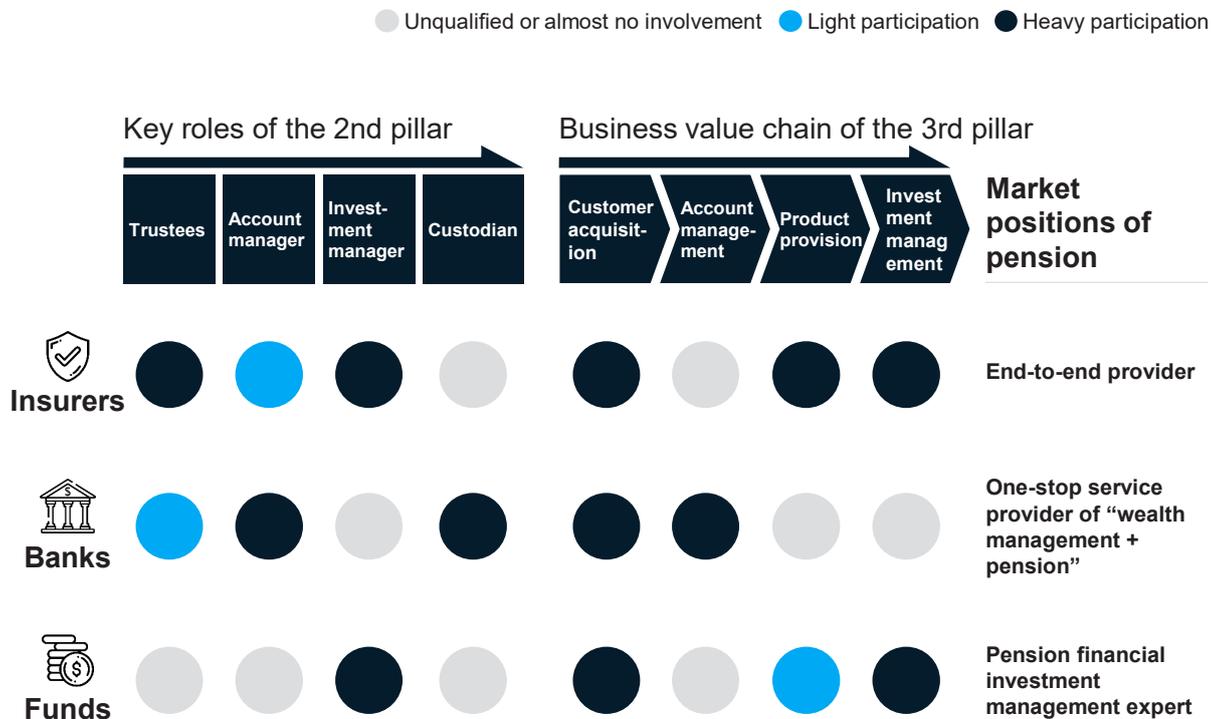
By implementing a multiparty pension finance education system throughout the country, we can help our people improve financial awareness, establish positive pension planning and investment management behaviors and mindsets, and enhance the retirement security of our citizens.

We need to consolidate the first pillar and standardize its payment models. The urban and rural components should be united into one national public pension. And we need to set up fiscal and tax policies to facilitate the expansion of both the second and the third pillars.



Chapter 3: Financial institutions' win- ning strategy in the com- mercial pension market

Exhibit 7: Major players in China's pension market



Source: Literature Research; McKinsey analysis

Commercial pensions go hand in hand with commercial institutes, all types of which are entering the commercial pension market via different positions

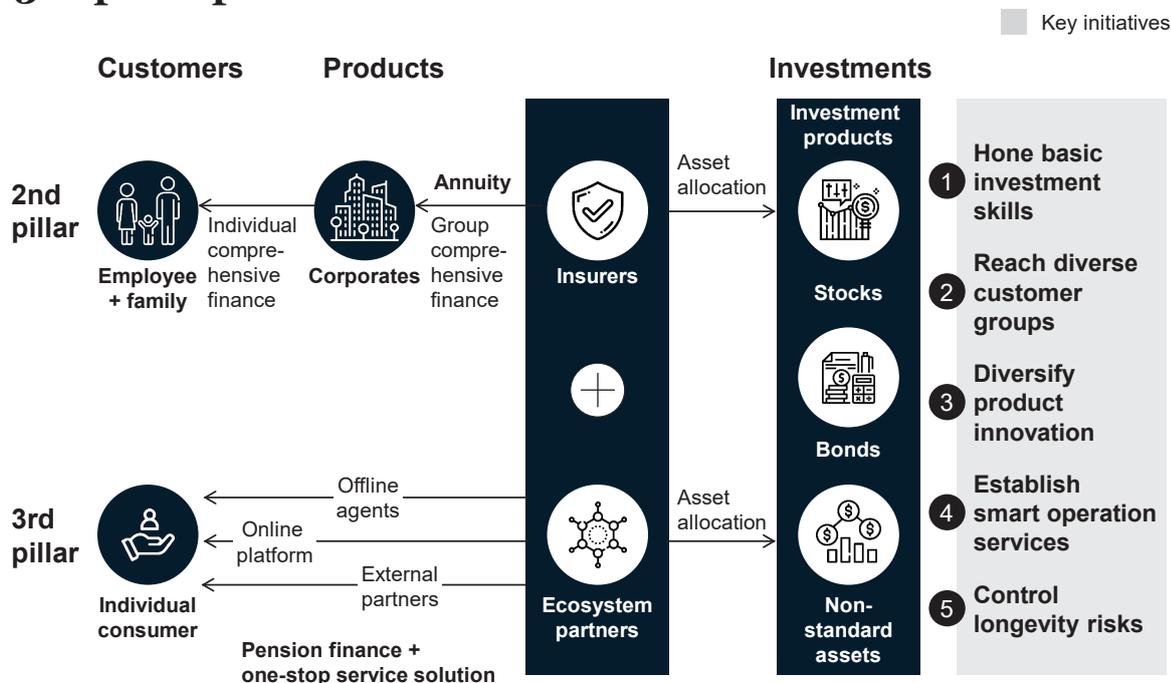
The second pillar of annuity business in China is subject to license granting, and approved financial institutions of each type play their respective roles: insurers and banks possess full license qualifications, but with a different focus. Using their unique strength in long-term asset management, insurers play the role of trustees and investment managers as providers of integrated annuity plans. Commercial banks act as account managers and custodians as providers of operational services, thanks to their advanced account management system. Public fund companies play the main role of investment managers due to their outstanding investment management skills. In addition, some trust and securities companies are also getting involved as trustees and investment managers, respectively. China's third-pillar individual commercial retirement fund just got started (Guideline on Retirement Target

Securities Investment Funds (Pilot) Nov 2017 by CSRC and Notice on the Pilot of Deferred Commercial Retirement Insurance for Individual Tax on April 2018 by MoF). It was initially decided that insurers and public fund companies should be the providers of core products, while banks should be account managers (Exhibit 7).

Insurers: strong first-mover advantages to become end-to-end service providers in commercial pension insurance

With the continual development of the pension commercialization reform in China, large insurers, which historically enjoyed unique policy advantages, have become important participants in China's pension market. Due to its full license qualifications, distinctive insurance product service capabilities, and extensive experience in insurance asset management, insurers enjoy first-mover advantages. They are set to become end-to-end service providers in the second- and third-pillar pension market. McKinsey believes

Exhibit 8: Insurers should leverage first-mover advantages to become end-to-end providers in the 2nd and 3rd pillar pension market



that insurers should focus on five areas to win in the Chinese pension market (Exhibit 8).

Hone basic investment skills

- Leverage insurance company's asset management capability and close the gap in securities/investment

Annuity customers value absolute guaranteed returns and low volatility in pension investment. Insurers can meet these needs by using their natural abilities in managing

insurance assets to further expand their advantages in configuring large-class assets and acquiring nonstandard products to improve their skills in managing annuity investments. However, compared with fund companies, insurers have weak investment skills in securities. Therefore, they should actively close this gap and improve their comprehensive investment management capabilities.

McKinsey believes insurers have strong first-mover advantages, and should focus on honing investment skills, reaching diverse customer groups, diversifying product innovation, establishing smart operation services and controlling longevity risk, which will help them become end-to-end commercial pension providers.

- **Break the stagnant talent management system and accelerate the development of investment teams**

In investment management, the capabilities of the investment team are core to improving financial institutes' investment levels. Currently, some domestic insurers' annuity investment teams suffer from a stagnant talent management system as well as from an ineffective compensation and incentive system, which result in the high turnover of top investment management talent and thus low-performing teams. Insurers should therefore adjust the current stagnant talent management system in terms of incentives, evaluations, and training. Available initiatives include adding quantifiable measurements like AUM size and long-/short-term performance to the evaluation system as well as inviting overseas investment management experts for professional trainings.

- **Develop a systematic investment management procedure**

As mentioned before, a top investment team is a core growth engine, while systematic investment procedures and methodologies are the cornerstone to guarantee a stable performance over the long term. Compared with international leading peers, domestic insurers rely more on individuals or departments for investment management. The lack of a companywide process or procedure negatively impacts decision making, which is very impulsive. Therefore, insurers should standardize key procedures in investment research, credit rating, risk management, post-investment management, and review. In addition, they should strengthen IT applications in each process and improve long-term investment and management skills.

Reach diverse customer groups

- **Promote investor education and improve pension finance awareness**

In recent years, Chinese consumers' awareness and acceptance of insurance products has improved significantly, especially of health products like CI. However, many consumers are not aware of pension savings and have very limited professional knowledge.

The CAFF50 Survey indicates that banks are the most important channel for consumers to buy pension products while insurers lag behind. It is understood that insurance agents do not have strong incentives to refer and promote commercial pension insurance products due to lower commissions. Therefore, insurance companies should use multiple methods to motivate agents and leverage other channels to inform consumers about and sell commercial pension products to them. First, consumers need to be segmented by industry, age, and family structure. Second, banca channels should be used, especially HNW private banks, to educate consumers about pension products.

- **Develop targeted data-driven customer marketing to improve acquisition efficiency**

Pension products cover a wide variety of target consumers – hence the right channels need to be selected based on each segment's age, occupation, and consumption habits. Compared with traditional tied agents, targeted data-driven online marketing can greatly improve customer acquisition. Insurers can partner with social media, search engines, or other internet companies to pinpoint users interested in pension products. Leading domestic financial players have already taken action with targeted marketing as well as tailor-made products and pricing. Pension insurance companies with weak digital capabilities should learn from these players and build online customer acquisition skills.

- **Improve tied agents' professional skills and enhance internal cross-sales**

Compared with other financial institutions, insurance agents have varied levels of professional skills but poor professional product knowledge and retirement advisory skills. Insurance companies should improve life insurance agents' knowledge of commercial pension products and enhance their professional skills to offer customers better-quality and comprehensive product consulting services. Secondly, it is necessary to strengthen the cross-BU cooperation within the group and unlock the vast amount of customer data available to them. Insurers would then be

B2B2C model is the key breakthrough to achieve profitability.

able to design targeted commercial pension product recommendations based on the unified internal customer data, thus fully seizing the opportunities of internal cross-selling.

- **Use the annuity business as a springboard to deep dive into business customers (B2B), individual customers (B2C), and data value**
The companies that established the annuity system are the largest and strongest in China. Their more than 20 million employees are among the higher income groups in China. Therefore, the group's customers and individual users brought by the annuity business and their network have great monetized value. Most financial companies that obtained the annuity license also have extensive comprehensive financial service capabilities. By using the annuity business as a springboard, they could establish a long-term cooperative relationship with business customers as well as employees to strengthen the group's integrated financial services and promote individual integrated financial cross-sales. China's leading insurance companies have started to provide group-comprehensive employee benefits for business annuity customers, but most of them do not have the ability to serve individual customers. To make a breakthrough in the B2B2C business, they should improve products, channels, and service operations. In addition, they could establish a long-term user relationship with employees and their families to gain data insights. Insurance companies should use data integration, big data analytics, and other means to fully unlock the data value, conduct more accurate marketing, and tailor services to individual users.

Diversify product innovation

- **Overcome the excessive pursuit of short-term performance and meet long-term pension needs of customers**
Currently, pension products are extremely homogeneous. The duration of most prod-

ucts is as short as three years, and medium- and long-term pension products are scarce. This is mainly because some insurance companies overly pursue the scale of short-term premiums at the expense of the essential demand of long-term retirement savings. In such a market environment, insurance companies should actively explore different types of commercial insurance products, move away from the mindset of pursuing short-term performance in product interest rate and duration design, and pay attention to new policy values and long-term stable return on investment.

- **Expand the scope of product services and provide value-added services based on retirement security to meet needs of one-stop pension services**
The boundary between pension and private wealth management is becoming blurred, with consumer needs for both increasingly overlapping. The one-stop solution of providing pension and services has become the development trend of the industry. As banks and fund companies entered the third pillar of the commercial pension market, the ability to provide value-added services and integrated financial solutions for retirement security purposes will become a differentiated competitive edge for financial institutions. Therefore, insurers should fully leverage resources within the group, actively expand the scope of services, and add pension insurance consulting services on top of insurance products, including pension investment advice, financial planning, family asset allocation, etc. For example, Fidelity offers value-added consulting services to its customers based on consumer needs. Its interactive intelligent service "myPlan" fully takes into account consumers' need for retirement income planning. Consumers cannot only create individual retirement savings plans, but also effectively predict the amount of money needed to achieve retirement savings goals to better optimize retirement plans.

Establish smart operation services

- **Establish an intelligent data-driven customer operation services system to realize process automation**

Under the influence of the fast-growing internet, most insurance companies in China have established basic front-end online self-service platforms and provide remote professional customer support, combining on- and offline functions. On this basis, how can insurance companies further promote the customer operation services system? From best practices of leading financial institutions at home and abroad, the key is to establish a complete and well-developed user data platform, including user labels, user historical behavior, and so on. At the same time, it supports the whole process service automation by combining the algorithm engine based on artificial intelligence.

- **Strengthen link between on- and offline services and improve overall customer experience**

While realizing an automated and intelligent customer operation service, the insurer should not ignore the development of their offline agent channel, especially in customer relationship maintenance and demand tracking. They should ensure the seamless connection between online and offline channels, improve customer experience, and look for the potential opportunity of the second sale and cross-sale.

Control longevity risk

With the significant increase of the life expectancy of the Chinese population, the development of the second and third pillars, and the increasing number of Chinese residents entering the pension stage, the risk of longevity will become more and more prominent in the future. As one of the main undertakers of the longevity risk, insurance companies' annuity and personal pension business will face the problem of an insufficient ability to make payments brought by the longevity risk. However, because the domestic capital market is not mature and the reinsurance market is just getting started, they cannot

fully meet the longevity risk transfer needs from the insurance company. Based on the experience of overseas mature markets, we believe that domestic insurance companies should recognize the necessity of longevity risk management as soon as possible. They also need to lay the foundation for longevity risk avoidance by optimizing product design, developing reinsurance, leveraging the financial market function, and investing in "reverse-risk" businesses.

- **Optimize product design**

More accurate life calendar should be used in product pricing, e.g., by increasing the frequency of life calendar updates and adding specific segments of the population to more closely track trends in population mortality. In addition, consideration may be given to adding a "reverse longevity risk" death guarantee liability to product terms as a natural hedge.

- **Explore the reinsurance market**

Currently, the number of providers in China's reinsurance market is relatively small, the reinsurance capacity is limited, and the technology level is not mature, which means insurers should keep an eye on it and explore actively.

- **Leverage the function of the financial market**

Although the domestic capital market is not yet mature enough to fully meet the longevity risk transfer needs in the short term, we can draw on the experience of European and US markets. With the further opening of the capital market, pension insurance companies could consider finding a counterpart with a natural preference for "longevity risk," e.g., life insurance companies, to exchange longevity risks (longevity swap), fully leverage market function, and build a risk hedge.

- **Increase investment in "reverse-risk" businesses**

Insurers could consider transferring longevity risks by investing in "longevity-favored" industries, such as nursing homes, elderly tourism, and biomedical start-ups.

Not everyone has insurance, but almost everyone has a bank (account). McKinsey recommends that banks should grasp customer touch points, export quality assets, and strive to become a “wealth management + pension” one-stop service provider in the pension market.

Banks should grasp customer touch points to become one-stop service providers of “wealth management + pension” management

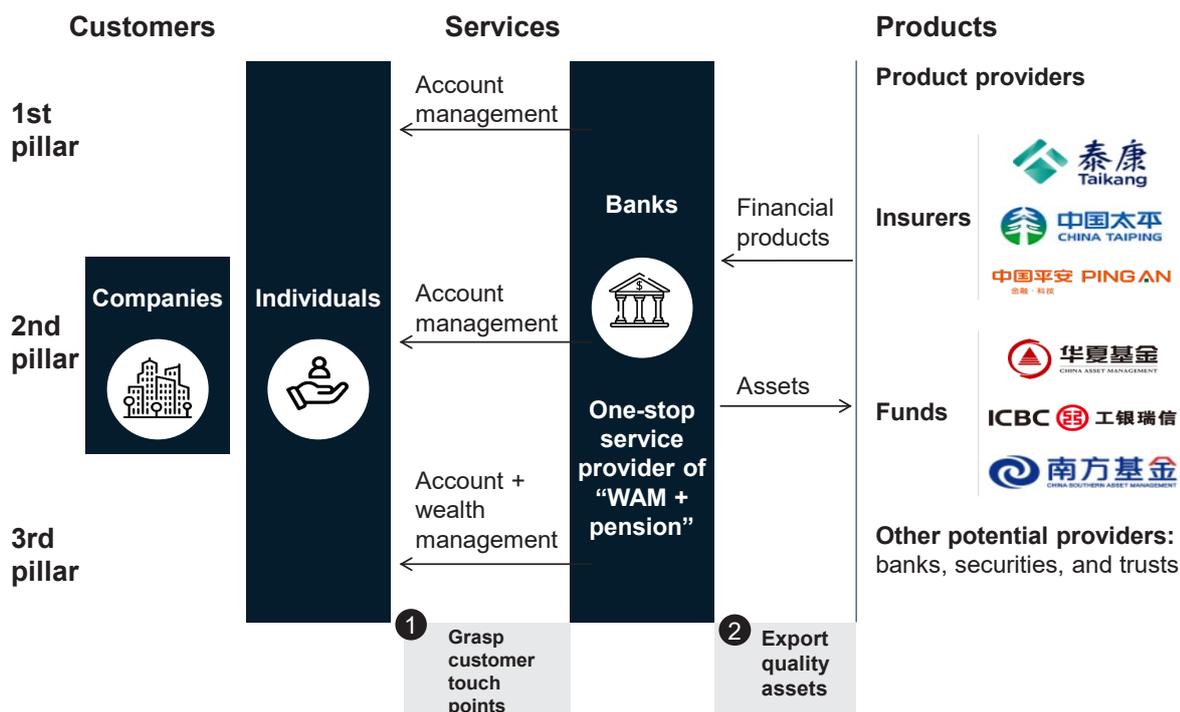
Not everyone has insurance, but almost everyone has a bank (account)

Compared with insurance and fund companies, banks have natural advantages in their channel footprint, customer resources, and brand reputation, which has become the most important traffic entry point to the retail financial market.

In addition, banks have taken on the role of account administrators in all three pillar businesses, with a different level of business intervention and a large number of users. In South Korea and Hong Kong, we have also observed that banks have become the core traffic entry point to personal pension products, such as insurance or funds, via personal wealth management. McKinsey recommends that banks should firmly hold on to customer touch points, export quality assets, and strive to become a “wealth management + pension” one-stop service provider in the pension market (Exhibit 9).

Exhibit 9: Banks should grasp customer touch points to export quality asset and become a one-stop service provider of “wealth management + pension”

Example Only



Standard Chartered Bank has partnered with Hong Kong's Manulife to offer Mandatory Provident Fund (MPF) products. It installed MPF agents at its outlets to provide long-term retirement savings planning consulting services to form a one-stop retirement pension service solution.

Grasp customer touch points to become a “wealth management + pension” integration consultant

With the increase of life expectancy, the boundary between pension and private wealth management is becoming increasingly blurred, and consumers' demand for both is increasingly overlapping. Providing integrated financial solutions will thus become the core trend of the future pension industry. Banks should consider using the pension and wealth management services to become one-stop service providers.

- **Banks have become the leading wealth management service providers in China**
Banks boast a wide range of outlets throughout the country, and they have become the main channel for diversified insurance and fund products and private wealth management. According to the 2017 CAFF50 Survey, 31.5 percent of consumers access pension investments and financial products through banks, as opposed to just 13.9 percent through insurance and 11.2 percent through fund companies. By providing a wide range of financial services (e.g., deposits, loans, credit cards), banks have established high-frequency contact with customers and accumulated a large amount of data, including consumption habits and capital status.
- **Banks enjoy unique advantages in the field of commercial pensions and can integrate customer touch points by breaking the bar-**

riers between account systems and data

China's second and third pillars currently have low penetration rates, and private pension management remains a new space for many consumers. Therefore, banks have a unique advantage in entering this open market. A bank holds many kinds of consumer accounts, e.g., savings, credit cards, and pension funds. By breaking the data barrier, banks can let users access their whole asset level and income on a single website. Meanwhile, banks can provide the data basis and operations to establish value-added services such as investment planning, retirement life planning, tax planning, etc.

- **Banks should establish their professional service ability of “wealth management + pension” based on customer needs and convert the touch point into traffic**
With the increasing awareness of insurance/wealth management and the mutual conversion of private wealth management and commercial pension insurance, domestic consumers wish to receive integrated professional advice on “wealth management + pension.” Leading domestic retail banks have established considerable wealth management service abilities. The core influence on consumption decisions is gradually shifting from product providers to banks, enhancing their power and benefit distribution in the value chain. Currently, the professional

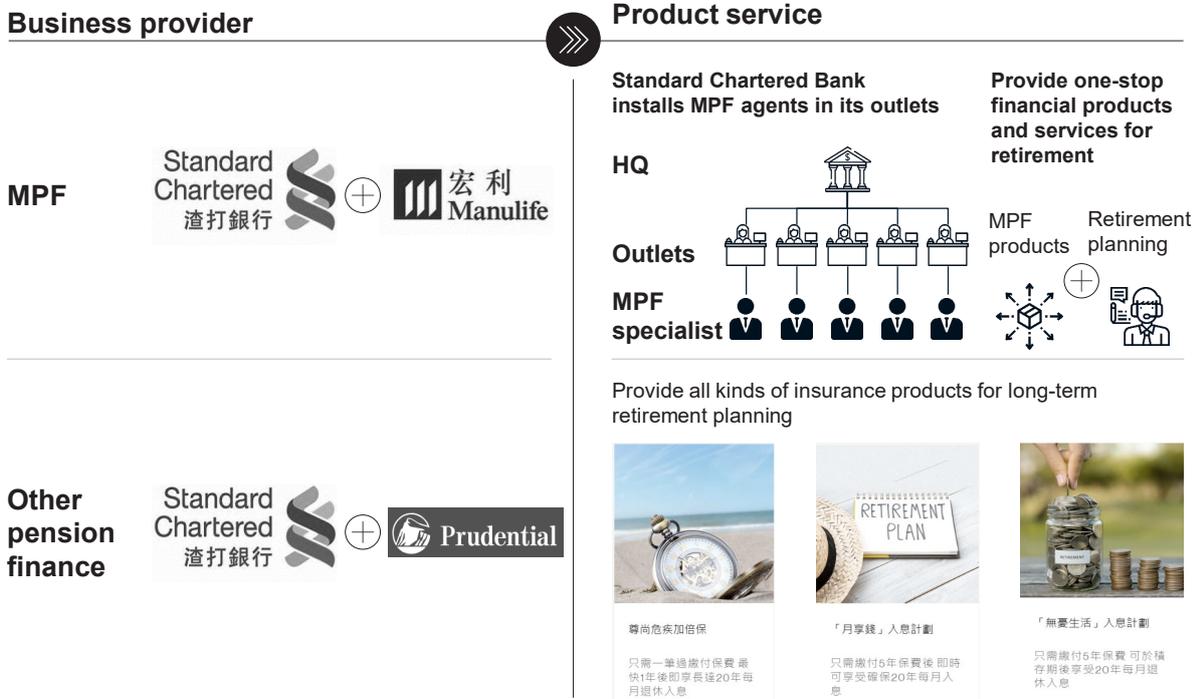
abilities of pension management and planning in China are still at quite an early stage. McKinsey suggests that banks should build up pension investment advisor abilities via self-development or work with insurers on the basis of wealth management. They should also pay attention to long-term return on investment and provide customers with comprehensive asset allocation suggestions, including pension. At the same time, banks also need to continuously optimize the portfolio of financial products to expand the range of options for investors. For example, Standard Chartered Bank and Hong Kong's Manulife have partnered to offer mandatory provident fund products, and Standard Chartered Bank installed MPF agents at its outlets to provide long-term retirement savings

planning consulting services to form a one-stop pension service solution. In addition, Standard Chartered Bank offers insurance products through partnering with Prudential to meet customers' diversified retirement wealth management needs (Exhibit 10).

Integrate group resources, export high-quality assets, and close the pension finance loop

Asset management companies affiliated with banks have unique advantages in resources and data risk control on assets. They hold comprehensive customer credit information to provide the pension investment management companies with high-quality assets suitable for pension investment, and thus can close the pension finance loop.

Exhibit 10: Standard Chartered Bank partners with insurers to establish “wealth management + pension” service abilities



Source: Standard Chartered Bank's Web site; McKinsey analysis

Fund companies: investment experts in the pension industry with rich product design and flexible configuration strategy

Just as supermarket shoppers like a full array of products, consumers are no longer satisfied with standard pension products

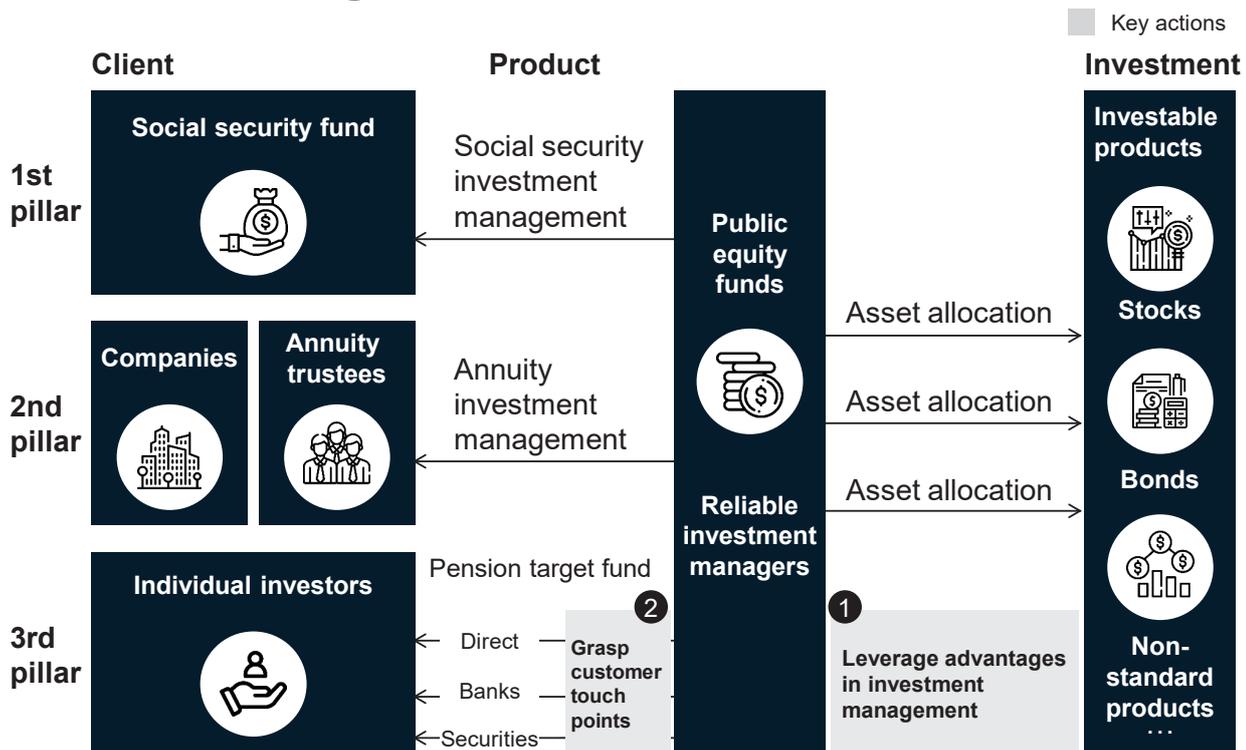
As consumer demands are growing and private wealth management and retirement financial investment are increasingly overlapping, more and more customers are no longer satisfied with standardized pension products. Instead, they have higher requirements on diversity, flexibility, and the return rate of investment products. The CAFF50 Survey shows that the most important factors influencing pension investment decisions are stability, safety, value appreciation potential, as well as the flexibility of investment and good credit of financial institutions. Compared with insurers, fund companies typically have higher returns on investment, more flexible designs, and are able to cater effectively to con-

sumers who become more sophisticated in terms of investment and finance. Learning from the successful experience of Fidelity and Vanguard, McKinsey suggests that domestic public equity firms should continue to leverage their own investment management advantages and actively promote investor education in order to increase brand influence.

Fully leverage the advantage of investment management and establish diversified investment abilities

Public equity firms play a very important role as investment managers in all three pillars of domestic pensions, accounting for 40 percent of the market share of the second pillar, with an average yield of 6.34 percent over the past six years – higher than insurers, securities firms, and bank investment managers. Annuity investment and the retirement target fund investment management are fundamentally different in product tool scope and investment management durations. Public equity funds should fully lever-

Exhibit 11: To become reliable investment managers, public equity funds should leverage their ability and build their brand images



Just as supermarket shoppers like a full array of products, consumers are no longer satisfied with standard pension products. McKinsey recommends that public equity funds should fully leverage the advantage of investment management and actively develop investor education and improve brand influence.

age their investment management advantage, further promote large-class assets configuration, and nonstandard assets' investment ability in annuity investment business. Retirement target funds should develop long-term investments as their core and provide corresponding support mechanisms.

- **Strengthen capabilities to allocate large-class assets and invest in nonstandard assets in the second pillar**

In the annuity market, public equity firms can only act as investment managers providing annuity pension products to corporate clients. Because the annuity market is relatively mature and public equity fund companies cannot play the role of trustees, their influence on clients is limited, and their front-end sales and customer operation ability is not the main competing factor. It is therefore necessary to focus on investment capacity building, mainly including large-class asset allocation capabilities and nonstandard asset investment capabilities. Annuity products have a variety of investment product configurations, including stocks, bonds, nonstandard assets, etc. However, traditional public equity funds tend to focus on a single type of asset investment, not paying enough attention to large-class asset allocation. At the same time, there are more investment restrictions, e.g., not being allowed to invest in nonstandard assets and their lack of investment experience. Some insurance companies, which are also active in investment management, have accumulated a great deal of asset allocation experience for their own insurance funds. Aside from this, they have owned more

nonstandard assets, such as infrastructure liabilities. Therefore, in annuity investment, public equity funds should actively build large-class asset allocation capabilities and further strengthen the advantages of stock investment to increase their competitiveness.

- **Establish a stable long-term third-pillar pension fund investment concept with a corresponding long-term investment-oriented support mechanism**

Referring to the international model and policy guidance of CSRC, we believe the pension target fund products' positioning is long-term held and long-term investment products. However, at present, domestic public fund equity companies are under great pressure for short-term returns, and the turnover of their personnel is relatively high. Therefore, most of them have not yet agreed on a long-term investment strategy. McKinsey recommends that public equity firms establish a stable long-term, corporate-approved investment concept for pension fund products to maintain the stability and sustainability of pension investment management. Meanwhile, they should build investment and team management capabilities, including investment and research abilities, with a focus on judging long-term economic dynamics (e.g., macroeconomic trends, aging of population) and optimizing the declining curve of asset allocation. In terms of management mechanisms, they should avoid short-term ranking and instead focus on the evaluation of long-term investment performances of fund managers.

In China, public equity funds need to actively develop investor education and improve brand influence

The nature of first and second pillar pension is a 2B business, therefore the key is to strengthen investment capabilities. While the nature of third pillar pension is a 2C business, serving both existing fund investors and large amount of consumers who have limited knowledge of financial investment. Consumers thus have difficulties with selecting fund companies, especially when comparing facts such as historical performance return, investment ability, or management scale, and therefore tend to choose companies with the best brand reputation and market trust.

- **Public investment philosophy education is a key lever to increase brand reputation and influence**

Current Chinese consumers tend to invest in retirement through bank wealth management and insurance products. According to the CAFF50 Survey (2017), only 13.2 percent invest for retirement through buying stocks or funds, whereas 30.2 percent invest in bank deposits/wealth management and 20.5 percent in commercial pension insurance. This is mainly due to consumers' lack of awareness of fund products and fund investments, insufficient access to fund products, or reluctance to choose fund products as a means of retirement savings investment due to short-term speculation losses. Therefore, public equity companies need to continuously promote multichannel investor education and services, basic knowledge of fund products, the concept of long-term holding through overseas case sharing and data analysis reports, as well as long-held fund investment modes. Therefore, consumers should be encouraged to choose long-term investment because the risks of pension fund products are stable, incomes are good, and the products meet the retirement demand.

- **Establish professional image of pension finance and promote brand influence**

Unlike fund investment users, most consum-

ers of retirement target funds lack an in-depth understanding of the fund's products. As the "shelf time" of these products is short, there is little variance in performance and a lack of long-term performance information. Therefore, brand popularity has become the decisive factor for investors to choose fund products. We suggest that public equity companies build a professional image of pension finance for consumers and regulators to promote social recognition, improve customer participation, and obtain regulatory policy dividends. Specific initiatives include the publication of studies and indexes and the participation in academic forums, etc. For example, since the establishment of the IRA in 1975, Fidelity has become the biggest pension financial platform in the United States by actively marketing its brand in newspapers and on television. After entering the Chinese market, Fidelity has also been working with Ant Fortune to release the China Pensions Survey Report (see Exhibit 12).

Building a "Health + retirement" finance and service ecosystem could be considered and explored by relevant enterprises

In the next 10 to 20 years when the 65+ age group will be retiring, people's consumption awareness, health habits, and retirement needs will keep changing. As a result, health and retirement service needs will also increase significantly and become more overlapped. Pension financial enterprises, represented by leading insurers, banks, and fund companies, have already invested different levels of capital in the healthcare service industry to develop a healthcare and retirement ecosystem. On the one hand, they should meet the end-to-end needs of "retirement + healthcare" to improve customer satisfaction and loyalty. On the other hand, they can nurture the pension financial business to improve their market competitiveness and hedge the longevity risks of pension products. At this

Exhibit 12: Fidelity, the biggest retirement financial platform in the US, has used multichannel marketing since 1975 to improve brand awareness

In the smartphone era, it released the film <Retirement Preparation> to promote one-stop service via mobile devices

2014



2005 In the TV era, it targeted “baby boomers” and used a song from a famous heavy metal band as the background music of its TV commercial



In the newspaper era, it introduced the IRA account and promoted its smartness, flexibility, and ease of use

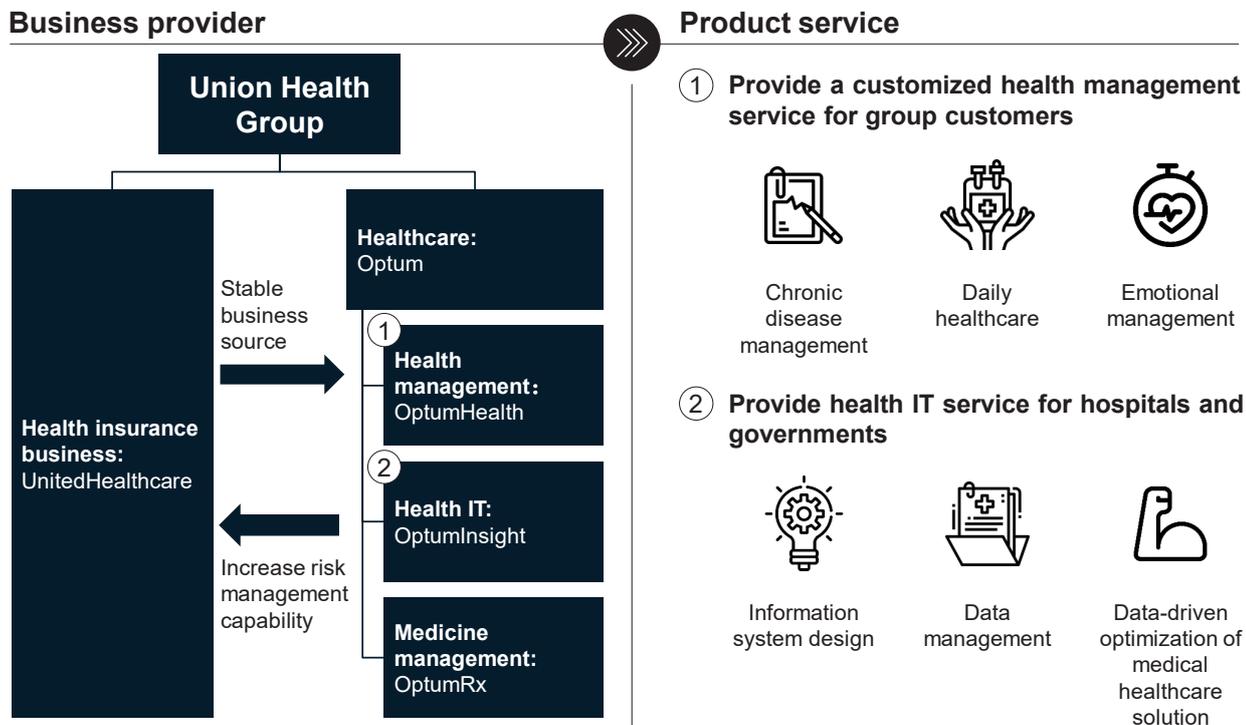
1975



stage, McKinsey has observed two main models of participation: one is an asset-heavy model, which provides a package of retirement solutions covering pension products, real estate sales, and elderly care and medical services through their own properties. The other is a light-asset model driven by technology and finance, with a health management and IT platform as its core. They will develop an ecological alliance with healthcare institutions and retirement community operators to provide insurance finance and health management services. In the latter model, technical capabilities and the setup of an IT platform is critical. Take the United States for example: due to its fully market-driven medical system, the “insurance + healthcare” solution

has become very popular. From the experience of United Health Group (UNH.N), we can see that a well-developed information system has become the core competence in its expansion to the health insurance and service chain. Its dedicated Health Information Technology Services Corporation under the OptumInsight Group focuses on core systems’ development and business data analysis. On one hand, it can enhance the health management service capability of insurance companies through technology. On the other hand, it can also effectively assist its insurance business, strengthen medical behavior monitoring, effectively reduce claims costs, and promote risk control (Exhibit 13).

Exhibit 13: Union Health Group deployed the health insurance business with IT as a core competitive advantage



Source: Web search; expert interview

There's ample room for imagination in the retirement ecosystem strategy, but at present, most enterprises are still testing the water and facing many challenges, including overall low profitability, long return cycle, difficult management of ecological partners, etc. They need to continue thinking and actively exploring, and the development of the ecosystem is an enormous task.

Interview with Tingjun Liu, CEO of Taikang Healthcare Investment Holdings Co. Ltd.



Tingjun Liu

- The Vice President of Taikang Insurance Group and Chief Executive Officer of Taikang Healthcare Investment Holdings Co. Ltd.
- Researcher, Dong Fujian Institute of Research at Wuhan University
- Member of the National Committee of Experts on Retirement Services of the Ministry of Civil Affairs
- Director of the Supervisory Board of the Insurance Asset Management Association of China (IAMAC)

Chinese tradition favors a stay-at-home retirement model, but it is facing more and more problems. Taikang has created a unique community of retirees, and the social response is very good. What's your view on the future Chinese retirement model?

The retirement model chosen should be based on the actual needs of the elderly.

The first view has to do with the way of living. Nowadays, the overall health of the elderly has increased gradually, and life expectancy has been prolonged. Many people hope to maintain a healthy and positive lifestyle that does not necessarily mean living for a long time, but living healthily, happily, and energetically. At the same time, retirees have more spare time, so making use of their time in a quality and meaningful way is also a focal point for the elderly. A large-scale retirement community is well-equipped and rich in activities, physical exercise, culture and art, social gatherings, and entertainment. Compared with traditional stay-at-home retirement, it has unparalleled scale advantages.

Next are the service capabilities. At the beginning, the ratio of service staff to the elderly in the Taikang Retirement Community was 1.6:1; meaning a single elderly person needed 1.6 professionals to serve them. But with the increase in community occupancy rates and the multidisciplinary collaboration and specialization of our

care teams, this ratio has fallen to 0.6:1, with a higher level of service and quality. In terms of nursing service professional abilities and service efficiency, the retirement community has more advantages than stay-at-home retirement.

Another area to cover is psychological needs. Many retirees are excluded from society, but they also have social needs. The most difficult problem to overcome is the loneliness of stay-at-home retirees. The retirement community can solve this problem very well, and its residents can interact and connect through activities, interests, and other means. In this way, the elderly can live in social environments on a continuous basis.

Finally, medical healthcare. From the perspective of medical services, large-scale medical healthcare communities can better supplement the current medical system. At present, the medical system in China is based on the treatment of diseases. The main task of the hospital is to diagnose and treat critical diseases. The closed-loop system of registration, treatment, hospitalization, and discharge is repeated every day. However, out-of-hospital services, including disease prevention, chronic disease management, general practice treatment, and rehabilitation are relatively lacking. The medical resources in hospitals are both tight and expensive, and the provision of these services will result in high-

Through continual improvement on service and operation quality, the ratio of service staff to the elderly in the Taikang Retirement Community has fallen from 1.6 to 0.6, showing advantage in comparison to stay-at-home retirement.

er costs and a waste of resources. So, it is not appropriate for hospitals to provide these services, and in contrast, healthcare communities can fill this gap. Rather than treatment, the elderly need GP services, chronic disease management, and rehabilitation care, especially for cardiovascular, endocrine, and respiratory chronic diseases. Large-scale retirement communities can set up their own community hospital. Each community of Taikang has a secondary hospital featuring general practice medicine, management of chronic diseases, rehabilitation care, diagnosis and treatment of common diseases of the elderly, and first aid care. The community can fully understand the patient's medical history and carry out all of the closed-loop health management, general practice medical treatment, and rehabilitation care services.

Taikang has spent 11 years in the retirement community and has basically developed a model combining the finance and retirement industry. What do you think are the core elements of Taikang's retirement model's success?

Taikang adheres to the coordinated mode of insurance, asset management, and medical care. In retirement real estate, we focus on asset ownership and independent operation, and our core need is to lock in the costs of the future. The biggest costs are land and rent. China's urban land prices have changed rapidly, and the asset-light model is not able to lock land prices. The next largest expense is the cost of service, so we insist on building an in-house team and independent operation. The ratio of our service staff to the community residents has dropped from 1.6:1 to 0.6:1, which underscores the improvement in our professional service capability and the cost advantage arising from improving

service efficiency. The third biggest cost is the capital complementarity of the insurance business and the pension investment. The insurance business generates a great deal of cash each year and has long-term investment demand, while retirement real estate is a good long-term investment object. With the increasing needs of Chinese retirees' health, the future return of retirement investment can be promising.

Meanwhile, we think that Taikang's model also has a certain threshold, which includes the capital threshold. With investments into each asset-heavy project of over RMB hundreds of millions or even billions and a long investment profit cycle, it requires stable capital support. What is more difficult to replicate is our management and operation threshold. The retirement industry covers a large span, which requires a multidisciplinary team, including engineering development, property management, hotel/apartment management, medical health management, retirement care services, etc. Thanks to our years of practice, we have developed a management system, which is our core competency. Finally, the threshold of our brand. As the early adopter of this model, Taikang has established a good reputation, which is our most important intangible asset. Additionally, we have also invested many resources into market promotion and customer service improvement to finally establish our Taikang medical healthcare brand image.

What do you think of China's future retirement finance system? For different financial institutions in the future, who will stand a better chance of sharing the dividends of the market?

China is getting old before it gets rich. Com-

pared with developed countries, China is generally unprepared for retirement and saving, which is the consensus reached by the government and industry. In the future, the government will put in place more policies to encourage individual pension savings. In accordance with international experience, the most common initiative is the introduction of tax incentives, which was already piloted in 2018. It is believed that similar policies will be further increased, deepened, and implemented in the future, which will open the door to enormous market opportunities.

The future market opportunities should be judged in light of China's national conditions. First of all, China's capital market is still relatively underdeveloped, and the acceptance of the capital market by the general public is still not high; thus, replicating the US-style "fund model" will entail some difficulties in the short term. Additionally, China's retirement health service market is huge, and there are great differences between urban and rural areas and among regions. Therefore, market dynamics can be set up in different places by various institutions, and economically advanced bay areas may be the first ones to try new business models. Finally, the financial knowledge of the general public in China is relatively low. Therefore, regulators need to adopt some prudent policies to protect the public, and regulation authorities will have a great and far-reaching impact on industry.

In general, the advantages of insurers are rela-

tively large, mainly because they have the skills and characteristics necessary for long-term investment, which is also what pensions require. In addition, insurance also gives a prudent impression that lets ordinary consumers have a natural sense of trust. From the regulatory pilot policies, it is also hoped that strong insurance institutions will take on this social responsibility. Banks also have their advantages, including their existing, large customer bases. City or town residents may not have insurance products, but generally they have bank accounts. If banks can boost their professionalism, and if regulation permits, they can certainly sell tax-deferred pension products for other institutions.



2018 was a memorable year for China's commercial pension reform. With the launch of individual tax reform, a tax-deferred pilot, and pension target fund pilot, the market-oriented reform of China's pension system has been launched. The commercial pension market will take a leap forward, and the leading insurance, bank, and fund enterprises will embrace a historic opportunity for development. We hope that the publication of this article will bring some thoughts and enlightenment to the development of the industry and that China's pension financial companies can grasp this rare opportunity to grow and contribute to the sustainable development of retirement industry in China.

On the Finance Practice at McKinsey Greater China

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