



Time for Asian Pension Systems to Take Center Stage

"YOU CAN BE YOUNG WITHOUT MONEY, BUT YOU CAN'T BE OLD WITHOUT IT." - TENNESSEE WILLIAMS

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In many parts of Asia, the population is aging rapidly without sufficient pension protection. In 2012, 11 per cent of Asia's population was 60 years and older, and this ratio is expected to double to 24 per cent by 2050. In 2011, labor force pension coverage in most Asian countries was below 40 per cent, while the size of private pension assets in a selection of nine Asian economies¹ with fairly developed pension systems amounted to only 5.3 per cent of GDP, compared with the OECD average of 70 per cent. For social protection and income equality reasons, and for the purpose of accelerating the deepening of capital markets in Asia, pension system reform is top priority, and Asian governments should consider the following five major strategies in their reform efforts:

- Maximize the coverage and the funded component of their pension systems (i.e. the defined contribution schemes) to supply the economy with a large pool of funds with committed long-term horizons;
- Deepen capital markets to provide pension fund managers with a wide range of investment options that ensure high returns on their long-term investments;
- Provide proactive regulatory support in terms of tax incentives for pension contributions. Liberalize current restrictions on asset allocation by pension fund managers by allowing them to invest in alternative growth assets apart from bonds and equity;
- Raise the level of professionalism and administrative expertise in pension fund management to maintain the trust of contributors and other stakeholders in the governance of the industry;
- Foster connectivity between pension fund managers and stakeholders through data availability and transparency.

¹ China, Hong Kong, India, Indonesia, South Korea, Malaysia, Philippines, Singapore and Thailand.

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INTRODUCTION

If Asia is to account for more than 50 per cent of global GDP and at least half of global financial assets and savings by 2050², it will need a financial system that has diverse markets and different institutions to effectively mobilize savings for investment in the development of the region in a stable manner. Pension funds feature as an important component of the Asian financial system because they are a major source of domestic savings and play a significant role in providing not only social security, but also in deepening the capital market and improving corporate governance.

In the advanced countries that have aging populations, pension funds are in crisis because funding deficits preclude them from adequately covering their aging population. The size of pension funds in the 34 developed economies of the OECD was US\$30 trillion or 70 per cent of GDP in 2011, and rose further to US\$33 trillion by the end of 2012, while the return on investment was a negative 1.7 per cent in 2011. Pension funds have also fallen behind the growth of the banking system between 2005 and 2011. OECD pension assets may have risen from 65 per cent of GDP in 2005 to 70 per cent in 2011, but during the same period OECD banking assets rose from 101 per cent to 114 per cent of GDP. Also during that time, global pension assets as a percentage of world GDP fell from 53 per cent to 47 per cent.

In contrast, private pension funds in nine Asian economies³ amounted to US\$663 billion in 2011 or only 5.3 per cent of GDP. Assuming Emerging Asian economies' GDP reaches US\$29 trillion in 2030, a rise in pension assets to 30 per cent of GDP would mean that nearly US\$9 trillion of pension funds would be available in the region for investment. Furthermore, as of 2011, there was nearly US\$3

trillion worth of pension assets in Australia and Japan combined, which are also actively seeking to diversify their investments in the Asian markets.

The upside potential growth of Asian pension funds is therefore tremendous and so is their potential contribution to the future growth of financial markets in the Asian region.

For pension funds to play an effective role in the future of finance in Asia, governments and policymakers will need to think about pension reform within a wider framework. Besides seeking to prepare pension systems for a rapidly aging population in terms of adequacy and sustainability, it is important to: improve the coverage and fairness of pension systems across different sectors of the workforce; have pension schemes that can accommodate labor mobility and urbanization; and, liberalize pension schemes to support deeper capital markets, while enhancing their resilience to market volatility and financial crises.

CURRENT STATE OF PENSION SYSTEMS IN EAST ASIA

Countries in East Asia are now experiencing the fastest rate of increase in aging. According to a United Nations (UN) study⁴, the number of people aged 60 years and older is projected to more than double from 450 million (11 per cent of the population) in 2012 to 1.2 billion or 24 per cent of the population by 2050, not far behind 27 per cent in North America and 34 per cent in Europe. An aging population combined with increasing longevity will in turn lead to another set of problems for pension systems, namely, a rise in the old-age dependency ratio⁵. According to UN estimates, the dependency ratio for the world as a whole will reach 25.4 per cent in 2050, from 11.7 per cent in 2010.

⁴ *United Nations Population Fund (UNFPA), Aging in the Twenty-First Century, A Celebration and a Challenge, New York, 2012.*

⁵ *The old-age dependency ratio measures the number of elderly people aged 65 and above against the number of people in the working age group of 15-64 years. A ratio of 25% means that one elderly person is being supported by three persons of working age.*

² Kohli, Harinder S., Ashok Sharma and Anil Sood, *Asia 2050: Realizing the Asian Century*. Sage, New Delhi, 2011.

³ China, Hong Kong, India, Indonesia, South Korea, Malaysia, Philippines, Singapore and Thailand.

At the top end of aging Asian countries is Japan, where the ratio will more than double from 35 per cent in 2010 to 74 per cent in 2050, followed by South Korea. At the other end of the spectrum is the rest of East Asia, where dependency ratios are still relatively low but are expected to rise rapidly in coming decades as in the case of China (11.6 per cent in 2010 and 38.8 per cent in 2050). Even in India, aging is also going to catch up, with dependency ratios of 8.7 per cent in 2010 rising to an estimated 21 per cent in 2050. If not addressed, the problems of this generation will have to be borne by the next generation.

ISSUES CONFRONTING PENSION SYSTEMS IN ASIA

Existing pension systems in Asia differ from country to country in terms of design features and institutional arrangements⁶, but share similar problems and challenges that revolve around fundamental issues of equity, adequacy and financial sustainability.

Equity: A majority of countries have a mix of pension systems that provide significantly different benefit levels with varying degrees of certainty to different groups. Most evident is the disparity between the defined contribution (DC) schemes of the private sector, and the more generous defined benefit (DB) schemes of the public sector.

Adequacy: The issue of adequacy of retirement benefits applies mainly to retirees in the formal private sector. Under the defined contribution schemes, the pension payments depend on the level of defined contributions by the employee and the employer, the length of employment and the returns on investment. Upon receipt of lump sum payments at the onset of retirement, the retiree has to bear the risk of longevity, in addition to investment

⁶ More detailed country reviews are available in a Fung Global Institute background paper: *Pension System Reform, Part 1: Mapping the Landscape - Survey of Pension Systems in Selected East Asian Countries, September 2012*

risks as many retirees lack financial literacy. In addition, the provision of pre-retirement withdrawal of pension savings to finance house purchases, medical and education costs will also exacerbate the adequacy problem. A relatively early retirement age of between 55 to 60 years in most Asian countries and an average life expectancy of 71 to 75 years also calls for adequate funds to provide for at least 15 to 16 years of post-retirement income security.

Sustainability: In most Asian countries, civil service employees are generally covered by government defined benefit schemes. Retirees receive a pension for life with the size of pension being defined as a percentage of the last drawn salary and length of service. DB schemes are non-funded pay-as-you-go (PAYG) schemes that use current government revenues to pay pensions. The replacement rate (i.e. the proportion of base salary paid as pension) for public sector schemes, ranging from 50 per cent to over 70 per cent in some instances, is comparable to the average norm of 57 per cent in OECD countries. However, as the income base is low in Asian countries, the adequacy of pensions remains an issue. Notwithstanding, the high replacement rate and increasing longevity are the main factors affecting the overall sustainability of defined benefit schemes. As the population ages, the fiscal burden of DB schemes will become greater.

Coverage: Coverage generally refers to the proportion of the labor force that is covered by mandatory pension schemes. For OECD countries, the coverage averages 83 per cent of the labor force. Most Asian countries have coverage rates of less than 40 per cent of the workforce with the high-population countries, including China, India and Indonesia clustered around the lower end of 10 to 20 per cent.

Returns on investment: Private pension funds in Asia are closely regulated and conservatively managed with most of their funds being invested

in low-risk and low-return portfolios, primarily in government bonds with smaller allocations in equities and real estate. Fortunately, Asian pension funds were not affected as badly as the European and Japanese pension funds, which suffered negative returns on their investments because of quantitative easing and low interest rates after the global financial crisis. However, the European and Japanese experiences have demonstrated how vulnerable pension schemes are to financial market volatility.

DIRECTION OF PENSION REFORM

Ongoing policy reactions and programs to reform pension systems typically address the adequacy issue through the common route of raising contribution rates, extending the retirement age and introducing additional savings for old age through voluntary private schemes (frequently referred to as the third pillar of pension systems). These policy reforms differ from country to country. However, the area that is gaining most interest from fund managers and workers of DC schemes, after experiencing the repercussions of the global financial crisis on the outstanding value of pension funds, is to look for investment products that would offer them greater protection against volatile financial markets and growing financing gaps.

As a result, new models to address funding gaps are emerging, many of which are seeing the advantage of diversifying the investment of pension funds into longer-term assets like infrastructure, including in energy, water and transportation. The Asian Development Bank Institute has estimated that Asia will need approximately US\$8 trillion to fund infrastructure investment between 2010 and 2020, or an average of about US\$726 billion a year⁷. With pension systems in Asia moving towards reform, pension funds can become an important source of investment capital for the long term financing of infrastructure in the region, just like the insurance industry and sovereign wealth funds.

⁷ Asian Development Bank Institute (ADBI), *Infrastructure for a seamless Asia*, Tokyo, 2009.

LINKING PENSION REFORM TO THE FUTURE OF FINANCE IN ASIA

Pension funds can contribute to financial stability in Asia by serving as a source of long-term capital for long-term investments in the real sector, thus removing the inherent maturity mismatch in banking systems that has more often than not, triggered past financial crises. At the same time, the mechanisms to mobilize the sizeable accumulated pension savings to support macroeconomic growth and financial market deepening are central to financial market reform in Asia.

Roughly, the nine Asian countries with fairly developed pension systems have an estimated combined total of private pension assets amounting to only US\$663 billion, or 5.3 per cent of GDP in 2011.

Size of Pension Fund Assets in Relation to GDP, 2011

| Region/Country | Pension Assets (US\$BN) | Per cent of GDP |
|----------------------------|-------------------------|-----------------|
| China | 41 | 0.6 |
| Hong Kong | 80 | 32.2 |
| India | 3 | 0.2 |
| Indonesia | 15 | 1.8 |
| South Korea | 196 | 17.6 |
| Malaysia | 145 | 50.3 |
| Philippines | 18 | 8.0 |
| Singapore | 145 | 59.2 |
| Thailand | 20 | 5.8 |
| Total Selected Asia | 663 | 5.3 |
| Total OECD | 30,497 | 70.0 |
| Of which: | | |
| Australia | 1,377 | 99.5 |
| Japan | 1,470 | 33.5 |
| United States | 17,578 | 117.2 |
| United Kingdom | 3,071 | 137.3 |

Source: OECD, TheCityUK estimates, and national sources.

Among Asian countries, only Singapore and Malaysia have pension assets-to-GDP ratios that are currently above 50 per cent, which are closer to the norms of developed countries. The other high-population countries like China, India, Indonesia, the Philippines and Thailand have a long way to catch up. If their pension reform measures can contribute to lifting the size of their pension assets to match the size of their economies, however, the amount of investable funds coming into the financial markets would be substantial. Assuming the GDP of Emerging Asia can reach US\$29 trillion in 2030 (Sheng⁸), and the pension assets to GDP ratio reaches 30 per cent in 2030, pension assets in Emerging Asia would be around US\$9 trillion.

The growing interest among developed pension funds to invest in alternative assets and in emerging equity markets that have strong growth potential suggests that emerging market economies are on the cusp of a global financial rebalancing trend that is moving in their favor. For emerging economies to take advantage of this phenomenon, regulators and policymakers will have to develop their financial markets and improve their competitiveness in order to capture these inflows of long-term capital.

A second, and equally important, suggestion that arises from these investment flows is that if developed pension funds are finding emerging markets attractive, emerging market pension funds should also be looking inward for investment opportunities instead of diversifying their portfolios abroad. In fact, if the asset portfolio of the global fund management industry is any guide, pension assets account for the highest share of total conventional assets under management (nearly 40 per cent in 2011), with the balance of 60 per cent split almost equally between insurance funds and mutual funds.

The importance of pension funds as a leading institutional investor and provider of social security and stability cannot be underestimated. Policymakers should give priority to establishing pension funds in many under-funded economies with tax incentives on pension contributions. Measures to liberalize current restrictions on asset allocation will allow pension funds to invest in alternative growth assets, and generate higher returns for their pensioners.

For a more detailed discussion on the role of pension funds in Asia, please refer to the Fung Global Institute Working Paper on Time for Asian Pension Systems to take Center Stage at our website: www.fungglobalinstitute.org

⁸ Sheng, Andrew, *Outlook for Global Development Finance-Excess or Shortage? United Nations, 2013. Emerging Market Economies (EMEs) are as classified in the World Economic Outlook of the IMF.*

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