

Pensions in Asia: Potential Becoming Reality

Bob Charles and Phil Collins of Watson Wyatt's regional Retirement Practice in Asia Pacific discuss emerging reforms in supplementary retirement benefits within the region.

Across Asia, there has long been a consensus in policy making circles that public social security programs cannot be the sole means of providing pensions. But, as in the rest of the world, pension reform is a politically sensitive issue and the role of the private sector has up to now been constrained. However, strides have recently been made. We believe that the long standing potential for a significant pension and retirement reform in Asia is now close to reality.

Where are we now?

Historically, supplementary retirement benefits in many parts of Asia been relatively underdeveloped. Why?

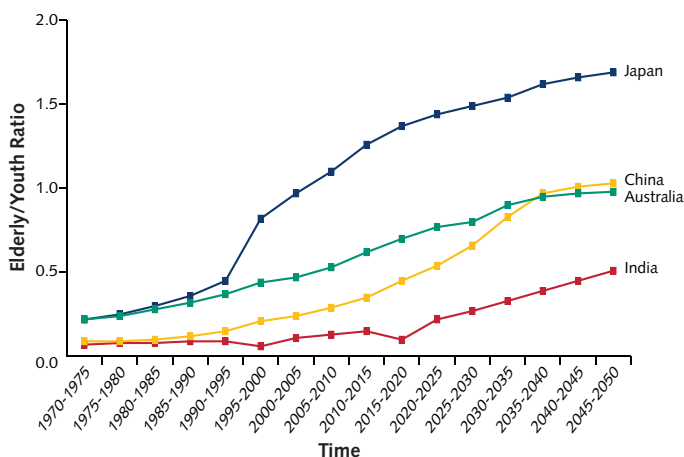
- The most common reason is that high levels of government social security contributions (such as China) or government run provident funds (such as India and much of South East Asia, including Singapore) have crowded out non-government providers. There has been limited room left in a typical corporate remuneration budget to provide extensive supplementary retirement benefits.
- Where employers have had statutory obligations to provide retirement benefits, these have been in the form of severance payments required by local labour laws (as in India, Korea, Taiwan and Thailand). Such obligations have generally been unfunded. They provide significant retirement benefits to long serving employees but they are not portable when employees change jobs.
- Savings rates are generally high in Asia. For example with a savings rate of 40% of GDP, China has one of the largest saving pools in the world. However, underdeveloped capital markets mean that returns on this savings pool are typically low. Governments control a high proportion of national investment and may not always channel funds into the most economically productive opportunities.

Why change?

Like the rest of the world, governments in Asia are now facing massive demographic shifts. The graph below shows the increase of the elderly portion of the population in selected Asia Pacific countries. The resulting pressures on government social welfare programs will be huge, and will force policy change.

The large populations of many Asian countries amplify the impact. China's problems are particularly severe. The "one-child policy" has created a rapidly aging population, whilst the legacy of state owned industries, many in parts of the country that have so far been excluded from economic development, leaves the Government with a massive pensions liability that has yet to be paid or adequately funded. The World Bank estimates that the unfunded pension liabilities for the urban population amounts to three-quarters of China's GDP or some US\$900 billion.

Developing funded pension schemes, with employers providing a cost effective means of distribution to individuals, is part of the strategy used by many Asian countries to transition towards a broader and more financially stable pensions system.



Source: UN, Population Division, Demographic indicators 1950-2050

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What is changing?

So where are changes being made across Asia? Key pension reform developments around the region are summarised in the following table:

	What's happening?	Status	Scope	Government or private sector providers?	Action for employers
South Korea	Option of funded system (either defined benefits or defined contribution), instead of unfunded severance payment system	Framework legislation passed on 29 December 2004, but more details awaited	Voluntary to opt out of severance payment scheme.	Private sector providers	Review likely strategy – details of the various options expected soon as the new legislation will take effect from 1 December 2005
Taiwan	New national defined contribution retirement savings system	Legislation passed – System commences 1 July 2005	Mandatory – Employers must contribute.	Choice between Government and private sector fund managers	Review any current supplementary plan Prepare communication strategy for employees options on 1 July 2005
China	Encouraging employers to set up pension funds	New rules effective from May 2004	Voluntary – Employers do not have to contribute but get tax benefits	Private sector providers	Review desirability of providing supplementary retirement benefits
India	New national defined contribution retirement savings system	Details awaited	Voluntary Additional to, i.e. not replacing, existing retirement system	Private sector fund management with a Government agency responsible for centralized contributions collection	Review desirability of funding mandatory and supplementary benefits (gratuity and superannuation) via group products provided by insurance companies
Singapore	Opening up Central Provident Fund to private sector fund managers	Details imminent	Mandatory	Private sector fund management for first time with a Government agency responsible for contributions collection	Await details – worth monitoring closely as situation may develop rapidly

A Framework for External Funding in South Korea

The South Korean government has announced proposals to allow employers to contribute to externally funded plans (providing either defined benefits or defined contributions) as an alternative to the current (typically unfunded) statutory severance scheme.

The new system is due to commence on 1 December 2005, although significant legislative detail is still to be announced by Presidential Decree.

Some issues remain open. What tax incentives will be offered? Will the transition to funded arrangements (which is currently voluntary for employers) eventually become mandatory? Will employees be able to access funds prior to retirement?

Furthermore, the growth and structure of such plans will also be significantly influenced by the reaction of employees and unions (since more than half of employees must consent to any changes in benefit arrangements).

Taiwan makes a move

Taiwan is the market of most immediate interest due to the imminence of the new Labor Pension Act – effective from 1 July 2005. This replaces the current mandatory severance obligations with a requirement for employers to contribute 6% of employees' salaries into a defined contribution retirement savings account on their behalf. Mandatory annual contributions are estimated to start at a level of US\$6 billion per year and the total could be higher as employees will receive a tax benefit if they also choose to contribute.

Employers may contribute to a government run fund, with larger employers having the option of selecting an insurance company with an “approved product” as the basis for their scheme. It may take some time before the market for such products becomes fully established.

Enterprise Annuities in China

In mainland China, employer based pension provision already exists to supplement social security benefits. Such supplementary provision is much needed (because of the well known deficiencies of the social security system), but investment vehicles are very limited and it is not generally possible to obtain a tax deduction on the employer's contributions. To this end the central Government's new “Enterprise Annuity” legislation, effective from 1 May 2004, provides a framework for companies, i.e. “enterprises”, to provide retirement benefits for their employees.

The Enterprise Annuity market will be tightly regulated. Employer schemes are to be set up under trust, with an approved administrator, asset manager and custodian. Asset managers will be subject to restrictions on investment policy. While up to 30% of the assets may be in equities, foreign investment is not permitted. Managers' fees are to be capped at 1.2% of plan assets and 20% of any fees levied must be retained as a reserve to cover any investment losses.

Notwithstanding the tight regulatory environment, the potential size of the Enterprise Annuity market is attracting significant interest from insurers and fund managers alike and we expect that attractive products will be available within a competitive market place.

Retention is a key issue for most employers in China and a supplementary pension plan can be a means of reducing turnover, although the pros and cons of pension versus other incentive plans will need to be considered according to each employer's particular circumstances.

Indian Public Sector Reform

In India, pension reform is currently focused on addressing the government's pension liabilities in respect of its own civil servants by introducing a defined contribution scheme for new employees. This scheme will offer competing investment products from selected private sector providers and will be coordinated by a central administrator.

Potentially the scheme could become very large, as it is to be opened up to all Indian citizens as a pension investment vehicle. However, the incentive for employers to contribute and the impact on existing retirement savings products are both presently unclear. India already presents opportunities for supplementary retirement benefits business in respect of gratuity and superannuation products under the existing corporate retirement system. These opportunities should be unaffected by the new system other than the potential confusion arising from overlapping pension regimes.

Outsourcing of Investment Options for Singapore's Central Provident Fund

Singapore's (long-standing) Central Provident Fund is currently assessing proposals to introduce Privately Managed Pension Plans (“PPP”) as investment options within the existing mandatory savings framework operated by the government. The PPP providers are to be responsible for fund management, with a single administrator appointed for collecting contributions and ongoing record-keeping.

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Will these changes defuse Asia's pensions "time-bomb"?

The reforms being pushed through across Asia mean that significant changes seem certain in the way employers provide for a share of their employees' retirement income. However, the legislative changes outlined above will not be sufficient on their own to provide adequate retirement savings to the 55% of the world's population who now live in Asia. Previous reforms, such as the Mandatory Provident Fund scheme legislation in Hong Kong, have been implemented successfully. But in some instances (for example Japan) they have tended to be characterised by inadequate tax incentives. Also, even where a legislative framework is successfully implemented (as in the cases of Hong Kong and Australia), setting a minimum level of mandatory employer savings can often mistakenly be seen (by industry and employees alike) as being sufficient to provide a sustainable income for retirement.

Addressing such problems in less developed countries within the region will be even more challenging. In distancing themselves from providing retirement benefits for all employees, the challenge for governments will be to provide sufficient incentives to employers to provide externally funded retirement savings for their employees. Meanwhile, the challenge for the financial services industry will be to provide high quality but cost effective products to the market place. Only then will governments be left free to focus on poverty reduction, rather than competing with industry to manage the savings of the relatively affluent.

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