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Pensions Innovation Comes to China

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(As published in Funds Europe, 8 November, 2016)

Many countries are committed to helping their citizens build adequate resources to live dignified lives in their older years, and pay-as-you-go public pension programmes have been the primary component of their retirement systems. But demographic trends have increased the costs of such pensions, spurring many countries to reassess the role of individual savings in these systems.

China is chief among those considering changes, due to demographic pressures it faces: The number of Chinese people 65 and older will double by 2050, when one in four of the country's 1.35 billion people will be at retirement age. Economic and mobility factors also are driving the need for more individual retirement savings. As more Chinese enter the middle class and move away from their ancestral homes, their financial goals change to include new demands for retirement preparedness.

All of these forces will require change in China. In response, China's leaders are revisiting the existing system and examining promising new options to meet the new demand for savings.

Three Challenges

China's pension system has three pillars. The first is public pension funds, the second involves voluntary occupational pensions in the form of enterprise annuities (EAs), and the third consists of voluntary private savings, which could evolve to include individual retirement accounts (IRAs). About 80 percent of total pension assets are invested in Pillar I, while 20 percent are invested in Pillar II. Pillar III is still under development.

The Chinese government faces three main challenges: first, diversify the investment of plan assets in Pillars I and II to improve returns; second, expand EA plans to more enterprises and employees; and third, build up the IRA system.

To meet the third challenge, Chinese regulators could launch a system with individual accounts that could invest in funds and other financial products. Such accounts can help boost retirement savings and create pools of long-term investment capital, fuelling long-term economic growth. In the US—a country with a population much smaller than China's—IRAs hold more than $7.4 trillion.

Chinese regulators would play a key role in building a similar system that works for their country. Among other challenges, they would need to set appropriate governance and oversight rules, and focus on such system design components as establishing tax incentives, creating guidelines for investor choice and control, and fostering a culture of longer-term investment.

Incentive

ICI Global was honoured to provide input to Chinese leaders recently. In April, working with the Asset Management Association of China (AMAC) and the Centre for International Social Security Studies at the Chinese Academy of Social Sciences (CISS CASS), we convened experts for the 2016 International Private Pension Systems Conference in Beijing. Key points from participants included the following:

- Systems can harness the power of inertia to change behaviour. Getting people started on the path toward savings helps keep them focused and committed to meeting financial goals. For example, the UK's National Employment Savings Trust (NEST) automatically enrols participants to get past barriers to saving, pushing participation in the country's private savings to new highs. Savers also embraced NEST's auto-escalation features and its focus on life-cycle or target date funds, which offer an asset-allocation mix that automatically adjusts as the investor nears retirement.
- Tax deferral can provide a strong incentive. In the US, tax incentives have fostered widespread savings in workplace and individual retirement plans. Employees are able to defer income tax on compensation set aside for retirement—both initial contributions and the income that their investments generate—until they take distributions from the account, usually in retirement. When workers change jobs or retire, they can take their pension accruals with them and continue to defer taxes by rolling them into IRAs.
- Every system will continue to evolve. No system remains the same forever. Rather, it's best to put a well-thought-out system in place and refine it as the system matures. Over time, plan providers and policymakers will find new ways to foster participation across income levels, encourage investor education and transparent fee disclosure, and ensure an appropriately wide range of investment choices.

Expanding EA Plans

China is taking these lessons to heart, examining existing pension schemes to determine where adjustments can be made. Specifically, leaders are seeking to increase returns on the National Social Security Fund with new rules allocating more assets (up to 30 percent) to equity investment. These investments can be domestic or international, and can be made by asset managers hired by the government to oversee part of the portfolio.

Chinese authorities also are considering expanding the EA plan savings programme. EA plans were first established in 2004. Currently, such plans are offered to employees of profitable state-owned enterprises. EA plan assets have grown recently at 20 percent to 30 percent a year, yet the overall participation rate is still very low. Regulators are now considering proposals that would expand the plans to more companies, including other public sector workers.

Long-Term Impact

China's regulators deserve great credit for considering these innovations. Their efforts could benefit not only citizens saving for retirement, but the Chinese capital markets—and even capital markets worldwide—by creating additional, stable pools of capital, held by investors with long time horizons.

Historical data show that as retail investors use funds as for retirement savings, they adopt a longer-term view and hold investments through market cycles, helping promote stability in financial markets. For example, in the US, less than 5 percent of retail investors—most of whom are saving for long-term goals, such as retirement—sold funds during the height of the market downturn in 2008. That commitment was good for the markets—and good for the overwhelming majority of investors, who stuck to their financial plans, rode the market back up, and recovered their losses.

Moves by China to improve and expand its retirement savings programmes will have a sweeping long-term impact on funds and their investors. To help savers reach their financial goals, the global asset management industry is committed to creating innovative products that are well-regulated and diversified. ICI Global and its members stand ready to partner with Chinese regulators and investors to strengthen the country's retirement savings system, and we applaud the efforts taken by Chinese leaders to date.

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