



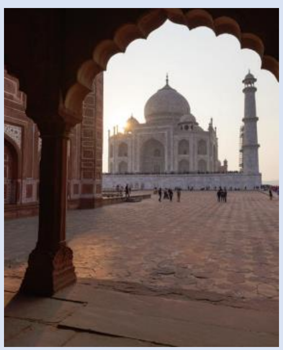


Voluntary Pensions in Emerging Markets

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Global Aging Institute & Principal Financial Group
Policy Forum

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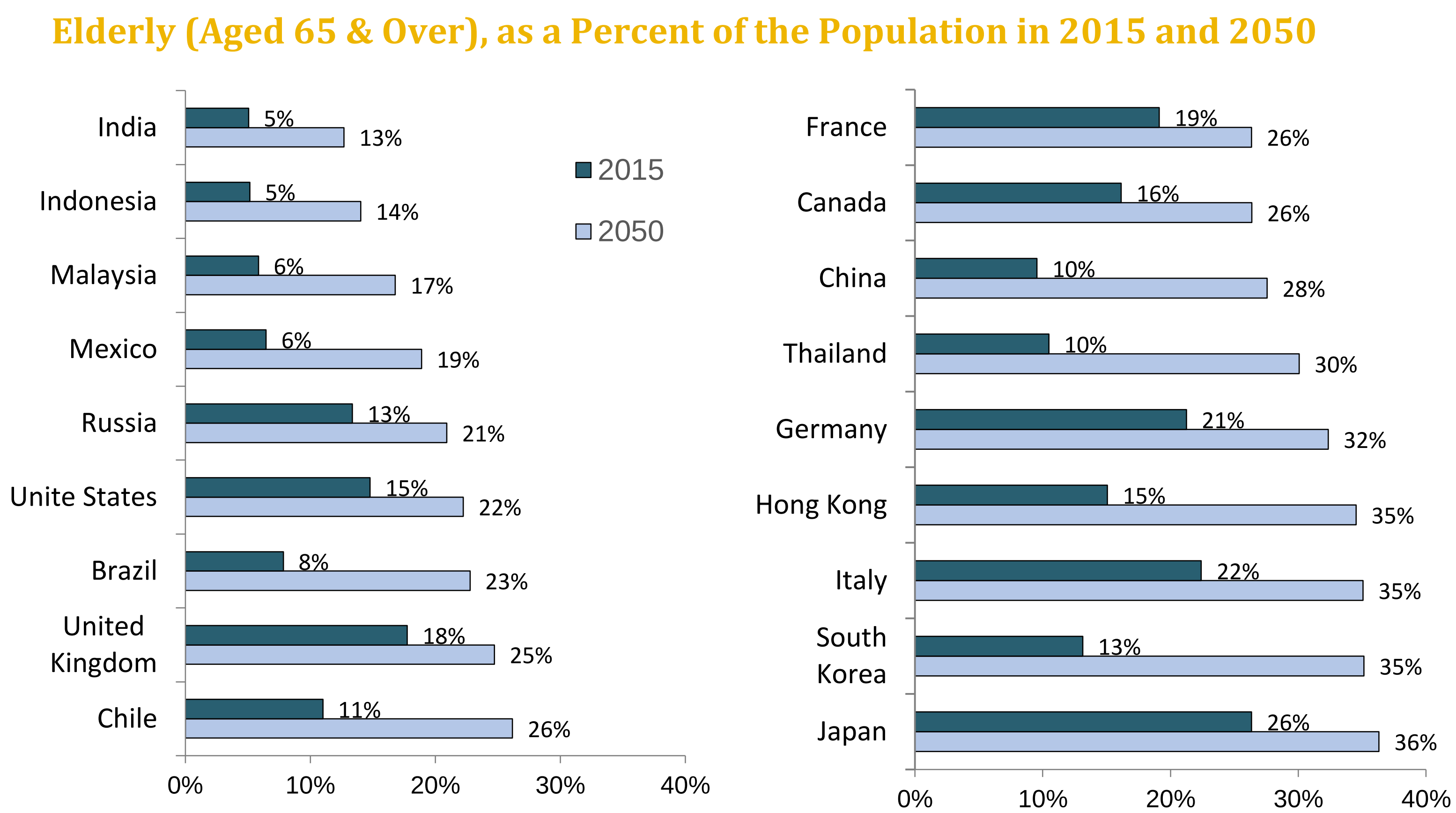
The Coming Crisis in Retirement Security

The emerging world is about to age dramatically.



Source: *World Population Prospects: The 2015 Revision* (New York: UN Population Division, 2015)

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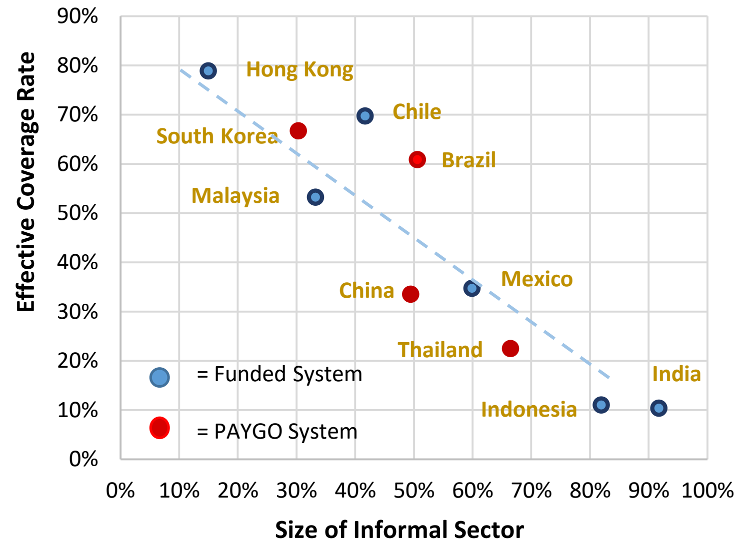
The Inadequacy of State Retirement Provision: LOW COVERAGE RATES

- Many workers in emerging markets fail to contribute to the state pension system, and even when they do contribute, they do so irregularly, which means that the benefits they receive will still be inadequate.

- In today's relatively youthful emerging markets, the limited reach of contributory pension systems is a serious economic and social concern. In tomorrow's emerging markets, with their soaring old-age dependency burdens, it could become an economic and social catastrophe.

Effective State Pension Coverage Rate and Size of the Informal Sector in the Most Recent Available Year



Note: The effective coverage rate is the share of the labor force that contributes to a country's mandatory pension system or systems in a given year. The informal sector is defined as informal employment in the nonagricultural sector plus agricultural employment as a share of total employment. Estimates of the size of the informal sector were derived by adding agricultural employment to published estimates of nonagricultural informal employment. In the case of Hong Kong, nonagricultural informal employment was also estimated by GAI.

Source: For the sources, which are too numerous to list here, see Richard Jackson, *Voluntary Pensions in Emerging Markets: New Strategies for Meeting the Retirement Security Challenge* (Alexandria, VA: GAI, 2017)

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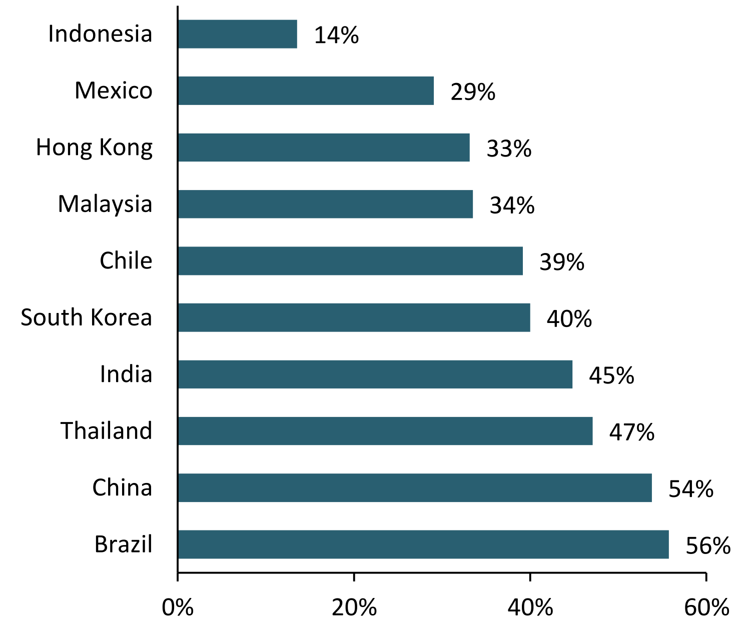
The Inadequacy of State Retirement Provision: LOW REPLACEMENT RATES

- From Brazil to China, emerging markets with PAYGO pension systems are making deep reductions in the generosity of state retirement provision as their populations age.
- In principal, emerging markets with funded state pension systems should be better positioned to confront their age waves. In practice, however, these systems are unlikely to deliver on their promise.
- In countries like Chile, Hong Kong, and Mexico with privately managed personal accounts systems, contribution rates are too low to finance adequate replacement rates.
- In countries like India and Malaysia with centrally managed provident funds, low returns on worker contributions, together with early retirement ages, mean that replacement rates will also be inadequate.

Future State Pension System Replacement Rates for Full-Career Workers



Note: The projections refer to final salary replacement rates for average-earning workers entering the labor force today at age twenty and retiring at their state pension system's normal retirement age. In countries where replacement rates differ by gender, the projections are male-female averages. For Brazil, the projections refer to the RGPS; for Chile, the AFP System; for China, the Basic Pension System for Urban Employees; for Hong Kong, the MPF; for India, the EPF and EPS; for Indonesia, Old Age Security; for Malaysia, the EPF; for Mexico, SAR; for South Korea, the National Pension System; and for Thailand, the Old Age Pension System.

Source: For the sources, which are too numerous to list here, see Jackson, *Voluntary Pensions in Emerging Markets*

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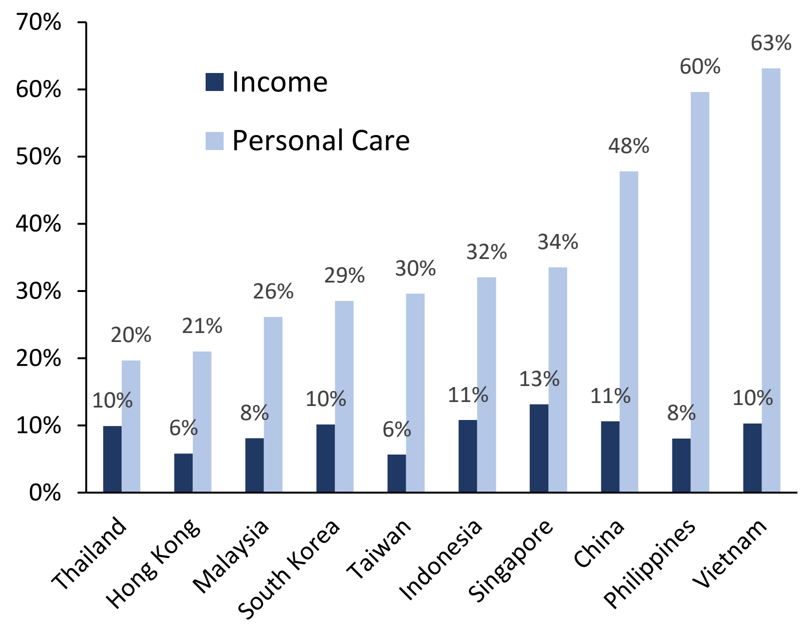
The traditional role of the family in retirement security is receding in emerging markets.

- For most retirees, alternative income sources will not be sufficient to make up for inadequate state pensions.
- As today's emerging markets develop and modernize, the expectation that the extended family will assume responsibility for caring for retirees is fading.
- Traditional family support networks, moreover, will soon come under intense new demographic pressure as populations age and family size declines.
- In Brazil and South Korea, the average number of children that the typical elder can turn to for support will decline by 1.7 between 2010 and 2040. In China it will decline by 2.3 and in Mexico by 2.4.

Shares of Respondents Saying "Grown Children or Other Family Members" Should be Mostly Responsible for Providing Income and Personal Care to Retired People



Source: Richard Jackson and Tobias Peter, *From Challenge to Opportunity: Wave 2 of the East Asia Retirement Survey* (Alexandria, VA: GAI, 2015)

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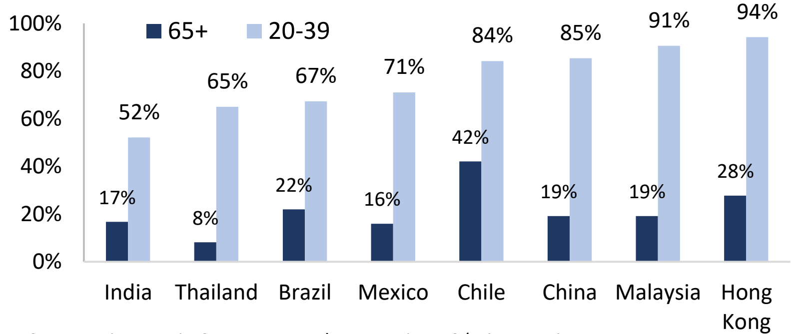
Neither continued work nor personal savings are likely to bridge the gap in retirement income.

- Continuing to work at least part time is an obvious way to compensate for inadequate state pensions. Yet across the emerging world, an enormous gap has opened up between the skills that older workers have and the skills needed to fill the jobs being created in the growth sectors of the economy.

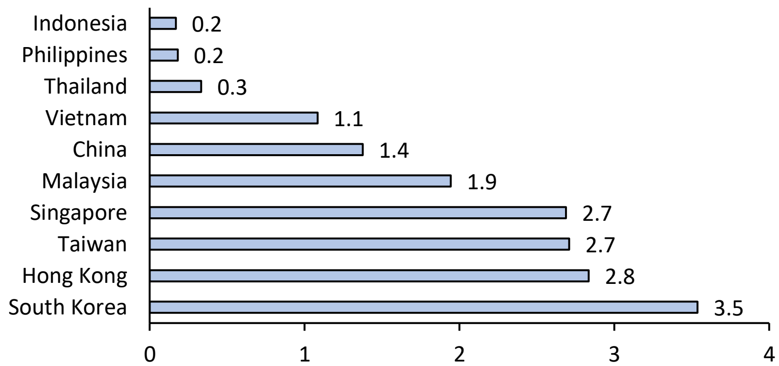
- As for personal savings, even in high-saving East Asia relatively few older workers have accumulated sufficient financial assets to finance more than a fraction of a retirement that might last 25 years or more.

Share of the Population with at Least a Lower Secondary Degree, by Age Group



Source: Wittgenstein Centre Data Explorer, Version 1.2 (Wittgenstein Centre for Demography and Global Human Capital, 2015)

Average Net Financial Asset-to-Income Ratio of Survey Respondents at Age 50



Note: Assets include all classes of household financial assets; ratios are averages for respondents aged 45-54.

Source: Jackson and Peter, *From Challenge to Opportunity: Wave 2 of the East Asia Retirement Survey*

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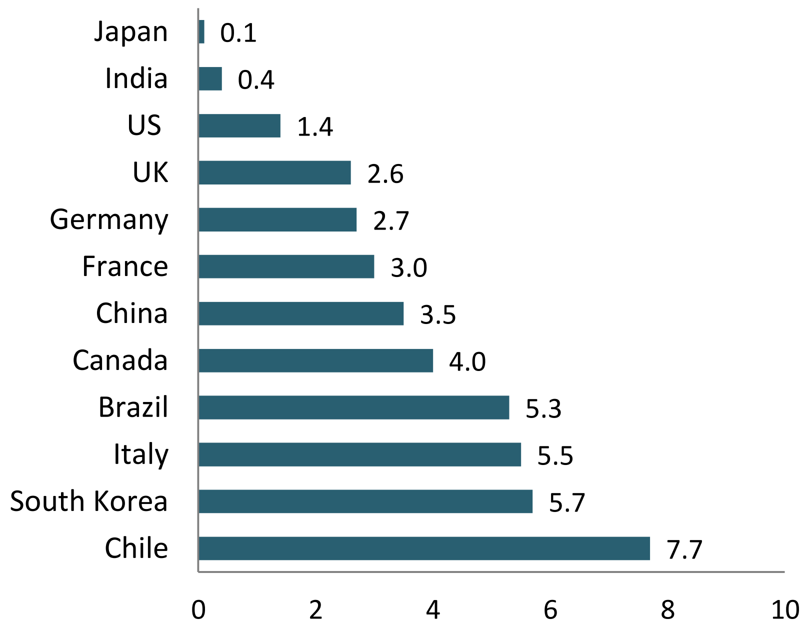
Meanwhile, rising life expectancy puts retirees at a growing risk of outliving what savings they do have.

- Since 1950, life expectancy in Latin America has risen by 23 years, while in emerging East Asia it has risen by 32 years. Looking to the future, the UN now projects that it will rise by another six years in Latin America and another seven in East Asia.

- It is worth recalling, moreover, that the history of life expectancy projections has been largely a history of embarrassing underestimates.

Change in Projected Life Expectancy at Birth for the Year 2050: UN 2015 Revision versus 2000 Revision



Source: *World Population Prospects: The 2015 Revision* and *World Population Prospects: The 2000 Revision* (New York: UN Population Division, 2000)

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The Case for Voluntary Pensions

- All of this suggests that the success of emerging markets at ensuring retirement security will increasingly depend on their success at building robust voluntary pension systems.

- Until recently, most policymakers assumed that expanding voluntary pension systems should be a low priority in societies where mandatory systems cover just a fraction of the workforce. But it is precisely the limited reach of mandatory systems that makes expanding voluntary ones so important.

- Nor is it true that expanding voluntary pensions need merely benefit the affluent. To the contrary, they have a crucial role to play in shoring up the deteriorating retirement income prospects of the middle class. They can even help to improve the retirement security of informal-sector workers, who currently have none at all.

GAI REPORT

- **Chapter 1**
  The Coming Crisis in Retirement Security
- **Chapter 2**
  Best Practices for Voluntary Pension Systems
- **Chapter 3**
  Lessons for Emerging Markets

Today’s Voluntary Pension Landscape

Some Good News and Some Bad News

- The GAI report focuses on eight emerging markets: Brazil, Chile, and Mexico in Latin America and China, Hong Kong, India, Malaysia, and Thailand in Asia.
- The good news is that the voluntary pension systems in all eight countries have certain positive characteristics in common.
- To begin with, almost all of the systems are exclusively defined contribution, which well suits them to the needs of mobile workforces and aging populations.
- All of the systems, moreover, benefit from at least some degree of favorable tax treatment designed to encourage voluntary retirement savings, together with well-developed fund management industries to invest the savings and professional regulators to enforce rules and standards.
- The bad news is that the voluntary pension systems in all eight countries have one critical failing in common: their limited reach.

COUNTRIES

BRAZIL
CHILE
CHINA
HONG KONG
INDIA
MALAYSIA
MEXICO
THAILAND

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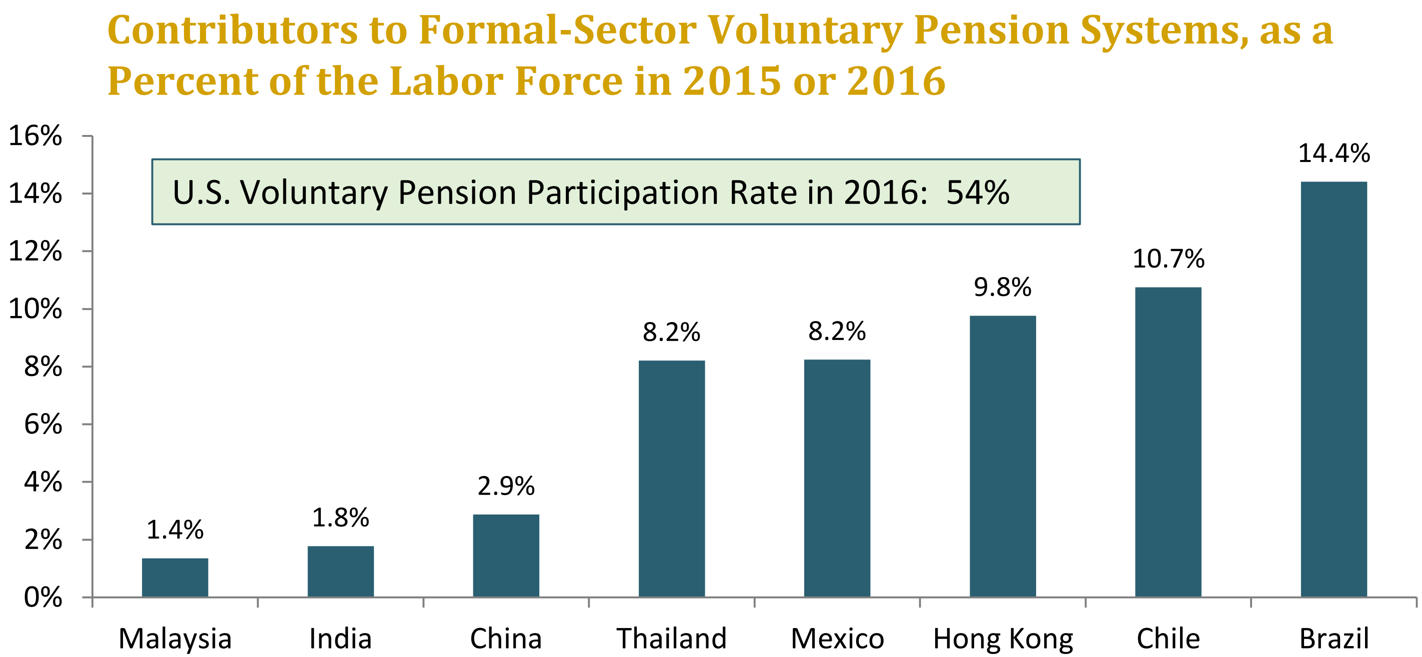
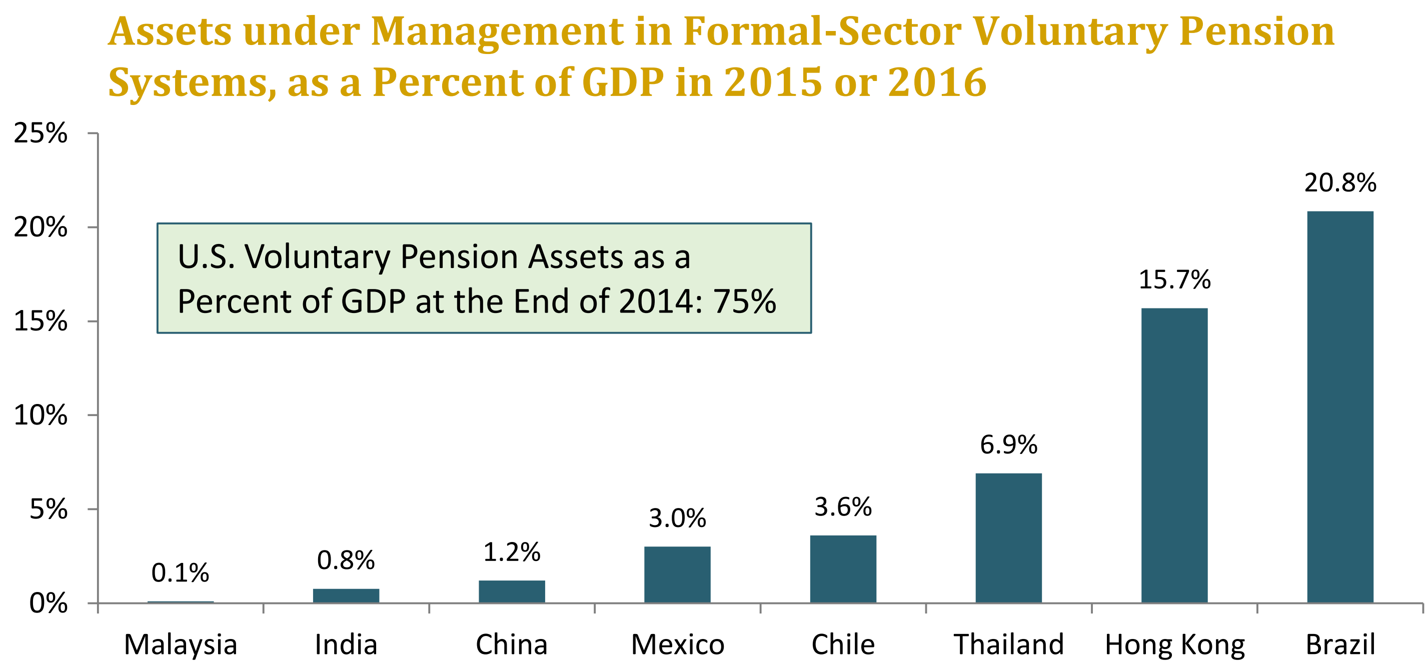
The Limited Reach of Voluntary Pension Systems: Only a small fraction of the workforce participates.



Note: Data for some voluntary pension systems were not available. The pension systems included are: for Brazil, Closed Funds and Open Funds; for Chile, APV and APVC; for China, the EA System; for Hong Kong, ORSO Schemes; for India, the NPS and PPF; for Malaysia, the PRS; for Mexico, APV and private employer pensions; and for Thailand, Provident Funds. The data for Chile and Mexico refer to the number of APV accounts (with more than a zero balance) rather than to the number of APV contributors. The data for the United States exclude IRAs. The data for India exclude central government and state and local government NPS contributors, for whom participation is mandatory.

Source: For Brazil, ABRAPP and FenaPrevi; for Chile, the Superintendency of Pensions; for China, MOHRSS; for Hong Kong, the MPFA; for India, the NPS Trust and Ministry of Finance; for Malaysia, the PPA; for Mexico, CONSAR; for Thailand, the Thai Provident Fund; and for the United States, the U.S. Bureau of Labor Statistics

The Limited Reach of Voluntary Pension Systems: Assets only amount to a small share of GDP.



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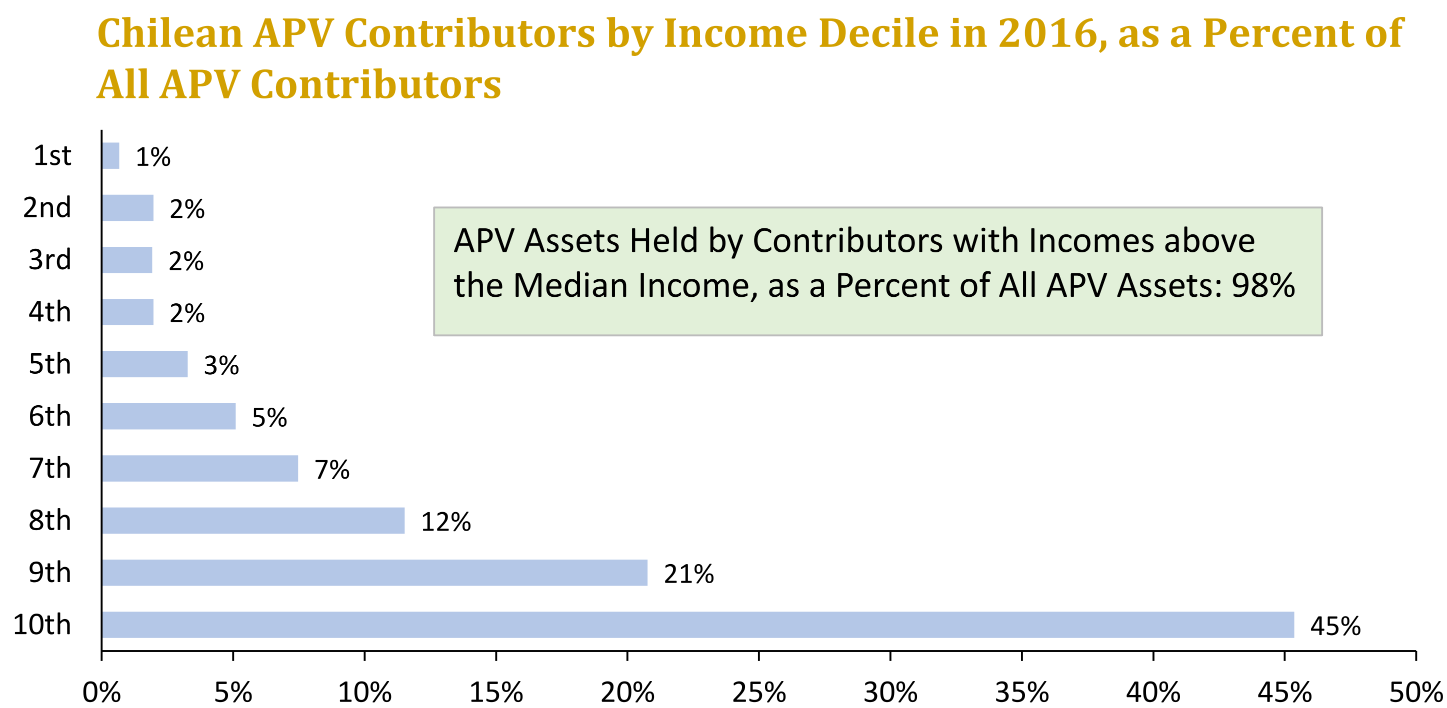
Source: For Brazil, ABRAPP and FenaPrevi; for Chile, the Superintendency of Pensions; for China, WillisTowers Watson, *Global Pension Assets Study 2017* (Arlington, VA: Willis Towers Watson, 2017); for Hong Kong, the MPFA; for India, the NPS Trust and Ministry of Finance; for Malaysia, the PPA; for Mexico, CONSAR; for Thailand, the Thai Provident Fund; and for the United States, the Board of Governors of the Federal Reserve System

The Limited Reach of Voluntary Pension Systems: Participation is highly skewed by income.



Note: The data refer to APV contributors to AFPs and exclude contributors to other qualified providers. Contributors are workers who made at least one APV contribution during the calendar year; income deciles refer to the income distribution of all AFP contributors; income refers to contributable wages.

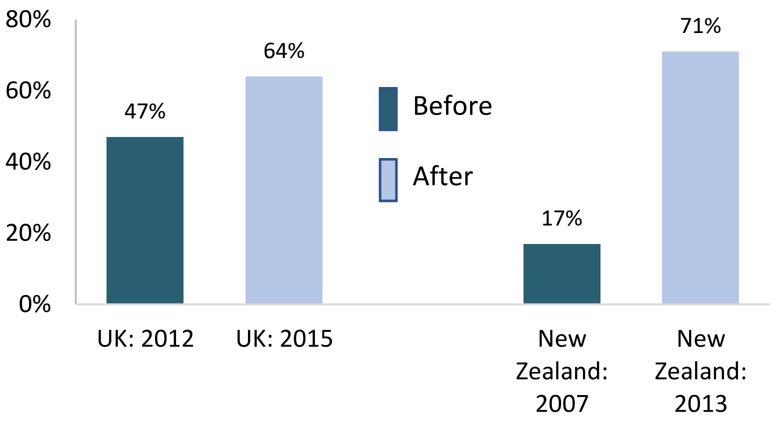
Source: Unpublished data provided by the Chilean Superintendency of Pensions

Strategies for Strengthening Voluntary Pension Systems

Soft Compulsion

- The experience of the developed countries teaches that switching enrollment from an "opt in" to an "opt out" model can increase participation in voluntary pension systems.
- At a minimum, emerging markets should require employers who sponsor a pension plan to implement autoenrollment. More ambitiously, they could require all employers to sponsor a plan in which their workers would then be autoenrolled.
- Autoenrollment can also be implemented in personal pension systems, provided they can use employers' existing payroll infrastructure.
- Countries with funded state pension systems could autoenroll all employees in those systems' existing voluntary tiers. Those with PAYGO systems could establish voluntary second tiers of funded "add on" accounts in which workers would be automatically enrolled.
- The experience of the developed countries also teaches that auto-sweeping, in which workers who opt out of a pension plan are periodically reenrolled, and auto-escalation, in which contribution rates are raised over time, result in greater participation and greater savings.

Percent of the Labor Force Participating in an Employer Pension Plan in New Zealand and the UK, before and after Autoenrollment



Source: *OECD Pensions Outlook 2014* (Paris: OECD, 2014); Office for National Statistics, *Annual Survey of Hours and Earnings Pension Tables: 2015 Provisional and 2014 Revised Results* (London: Office for National Statistics, March 2016); and GAI calculations

Economic Incentives

- Beyond leveraging the lessons of behavioral economics, emerging markets need to do much more to incentivize retirement savings among middle-and lower-earning workers.
- Global best practice calls for combining standard tax preferences, which mostly benefit higher-earning workers, with government subsides and matches, which tilt the other way.
- Along with automatically enrolling workers in the voluntary tiers of state pension systems, governments should supplement their savings with flat subsidies and/or matching contributions.
- Governments could also supplement the savings of workers in employer pension plans, as both New Zealand and the UK do.
- Although all of this will be expensive, in the long run the cost of more generous government subsidies for voluntary retirement savings will be far less than the cost of social pensions for workers who arrive in old age destitute.

- In New Zealand's KiwiSaver Scheme, autoenrollment and government matching contributions helped to boost participation from 17 percent of the workforce in 2007 to 71 percent in 2013.
- In Germany's Riester Pensions, government savings subsidies have helped to achieve broad participation among workers at all income levels.

Accumulation Phase

- **Portfolio Allocation**: The success of any funded pension system requires a liberal investment regime that allows fund managers to earn the global rate of return to capital. Regulatory limits on foreign investment are particularly damaging.

- **Individual Choice**: Although mandatory pension systems can severely restrict investment choice, voluntary systems must allow for greater individual discretion. Global best practice calls for combining a well-designed default fund based on lifecycle investment principles with a limited panel of additional fund options.

- **Benefit Guarantees**: Benefit guarantees are costly and counterproductive. If a guarantee is deemed politically necessary, a nominal capital guarantee is less harmful than a rate of return guarantee.

- **Portability**: Voluntary pension systems must provide for mechanisms that permit the full portability of retirement savings.

- **Preretirement Withdrawals**: While all pension savings would ideally be preserved for retirement, voluntary systems must allow preretirement withdrawals in order to encourage participation by liquidity-constrained workers. Governments, however, should limit, penalize, or otherwise discourage them.

- **Administrative Fees**: The best approach to limiting fees is to promote efficiency-enhancing competition among fund managers. Regulatory caps can distort investment decisions and have unintended and self-defeating consequences.

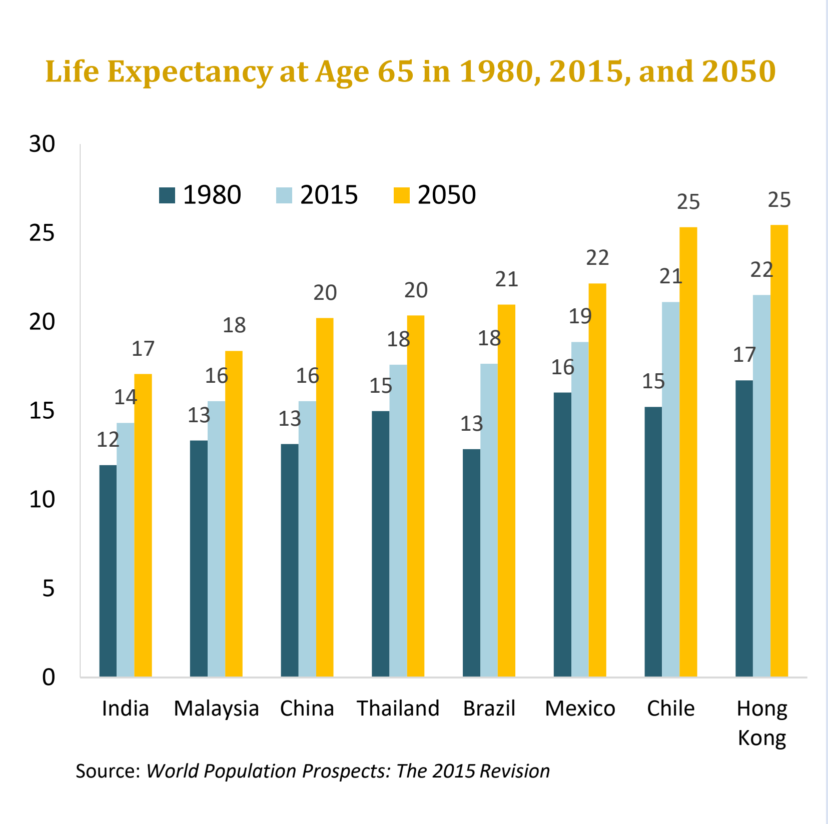
Payout Phase

- Actual practice during the payout phase of the voluntary pension lifecycle diverges widely from global best practice in most of the eight countries covered in the GAI report.

- Although a few of the countries, including Brazil and Chile, allow workers the option of annuitizing voluntary pension savings, only India requires even partial annuitization.

- Emerging markets would do well to reassess the wisdom of allowing unrestricted lump sum withdrawals and, as the OECD recommends, consider requiring that retirees combine programmed withdrawals with a deferred annuity.

- They would also do well to reassess whether current preservation ages, which in some countries are as low as 55, match the needs of their rapidly aging populations.



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Public Education

- Whatever reforms emerging markets enact, they will need to be accompanied by a large-scale public educational campaign involving both the government and the financial services industry.

- Much of the workforce in emerging markets not only knows little or nothing about the importance of voluntary retirement savings, but lacks even the most basic financial literacy.

- As part of this effort, it will be critical to educate the public about the benefits they will receive from mandatory pension systems, since in many countries unrealistic expectations minimize the perceived need for voluntary retirement savings.

- To be effective, the campaign will naturally need to be tailored to the cultural and institutional environment in each country.

- In Asia, where household savings rates are generally high, the challenge is to persuade people to save for the long term. In Latin America, where household savings rates are generally low, it is to persuade people to save at all.

- In Mexico, just three in five workers enrolled in the country's mandatory personal accounts system know that the system also includes supplemental voluntary retirement savings accounts.

- In India, retirement ranks fifth in the list of reasons that people give for saving—after saving for a house, saving for their children's education, saving for their children's marriage, and saving for a car.

The Special Role of Employer Pensions

- In most developed countries, employer pensions have proved to be the most effective and efficient way to extend voluntary retirement savings to the broad middle class.

- The scope for expanding employer pensions may be more limited in some emerging markets. For one thing, they cannot be extended to the informal sector. For another, they are better suited to economies dominated by medium and large employers than ones dominated by small employers and microenterprises.

- Yet wherever possible, emerging markets should prioritize the development of employer pension systems. The surest way to expand employer pension coverage is to mandate it. Unfortunately, many emerging markets, just like many developed countries, may find it difficult to build the political consensus needed to take this step.

- The good news is that there are ways to expand coverage without a mandate. One is to require autoenrollment in existing employer pension plans. Another is to give employer pensions more favorable tax treatment than personal pensions, something that has helped propel the expansion of the 401(k) system in the United States.

- Along with expanding the reach of employer pension systems, emerging markets need to improve their adequacy and equity.

- Enhanced tax preferences should be linked to nondiscrimination tests that make eligibility for the tax preferences contingent on employers including rank and file workers in the plans.

- There should also be minimum thresholds for employer contributions and matches and maximum thresholds for vesting periods.

A New Approach to Retirement Security in the Informal Sector

- Many experts are concluding that voluntary pensions are a better response to the problem of old-age insecurity in the informal sector than social pensions.
- While social pensions are a necessary near-term palliative, they encourage labor-market informality. They also leave a large share of the elderly dependent on government social assistance—and vulnerable to benefit cuts as societies age and fiscal pressures grow.
- Voluntary retirement savings does not have these drawbacks, which is why a growing number of countries, especially in Asia, are designing special voluntary pension systems for the informal sector.
- Among the eight countries covered in the GAI report, China, India, Malaysia, and Thailand have recently launched such systems.
- Extending voluntary retirement savings to informal-sector workers poses major challenges, including how to collect and route contributions.
- Economic incentives also need to be more generous than those for formal-sector workers, at least relative to participants' incomes. Most voluntary pension systems for the informal sector therefore include sizeable government matches.
- If workers are to be persuaded to participate, these systems must also allow for considerable flexibility in everything from contribution requirements to withdrawal rules.
- Although it is too soon to gauge the success of most of the new informal-sector pension systems, the results in at least one country have been spectacular: China.

Conclusion

Summary

- Without reform, a large share of the workforce in most emerging markets will reach old age over the next few decades without adequate pensions, personal savings, or children to support them.

- The success of emerging markets at ensuring retirement security will increasingly depend on their success at building robust voluntary pension systems.

- Although the eight Asian and Latin American countries on which the GAI report focuses have all made a promising start, all have a long way to go.

- To shore up the retirement prospects of formal-sector workers, governments will need to broaden and deepen voluntary pension systems that now serve just a privileged minority of the labor force.

- For too long, policymakers in emerging markets have focused on trying to expand the coverage of mandatory pension systems, usually unsuccessfully, while promoting voluntary pensions has been almost an afterthought.

- It is time to recognize that, in societies where the reach of mandatory pension systems is so limited and whose populations are aging so rapidly, voluntary pensions are an essential component of retirement security.

- At the same time, governments will need to build entirely new voluntary pension systems tailored to the needs of informal-sector workers, who currently enjoy no real retirement security at all.

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New Strategies for Meeting the Retirement Security Challenge

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