



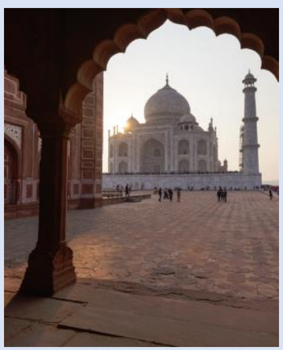


Retirement Security in Emerging Markets

The Case for Voluntary Pensions

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October 29, 2020

8th Edition Global Pension Programme

GAI Global Aging Institute

The Coming Crisis in Retirement Security

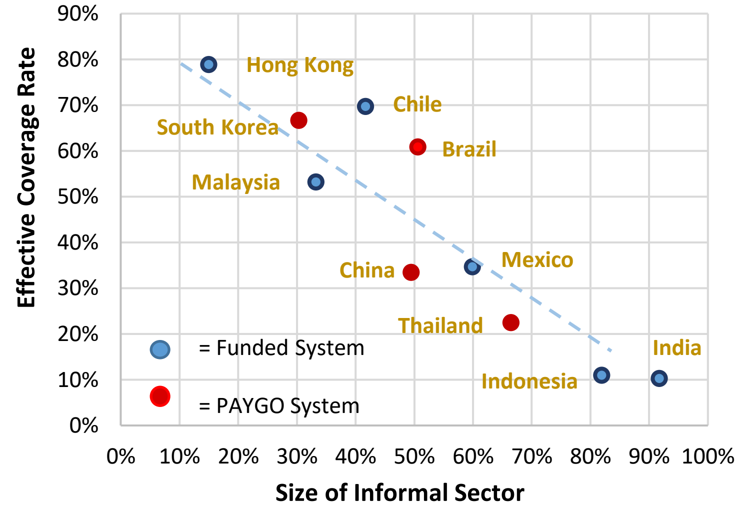
Inadequate State Pension Systems:
LOW COVERAGE RATES

- 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 may still be inadequate.

- Low coverage and low contribution density are a function of labor-market informality, not pension system design. When informality is high coverage and contribution density are low, regardless of whether the state pension system is fully funded or pay-as-you-go.

- In today's relatively youthful emerging markets, the limited reach of state 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 2016 or 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: Richard Jackson, *Voluntary Pensions in Emerging Markets: New Strategies for Meeting the Retirement Security Challenge* (Alexandria, VA: GAI, 2017)

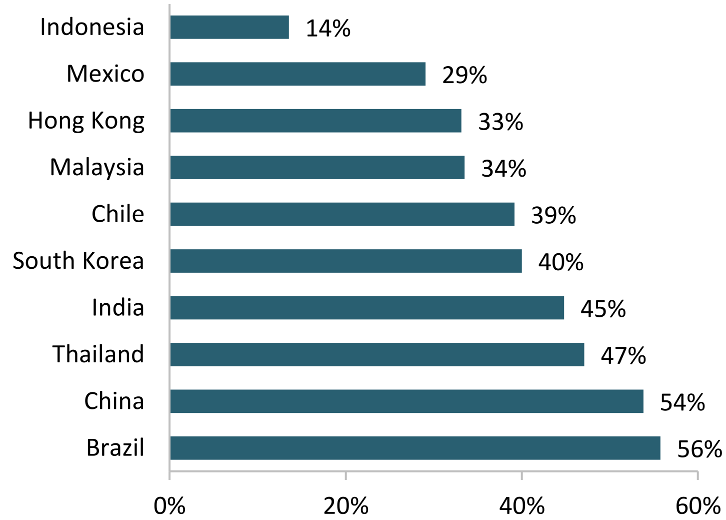
Inadequate State Pension Systems:
LOW REPLACEMENT RATES

- From Brazil to China, many emerging markets with pay-as-you-go pension systems are being compelled to make deep reductions in the generosity of state retirement provision as their populations age.

- In countries like Chile, Hong Kong, and Mexico with privately managed personal accounts systems, contribution rates are often too low to finance adequate replacement rates.

- In countries like India, Indonesia, and Malaysia with centrally managed provident funds, low returns on contributions, together with preretirement withdrawals, can also result in low replacement rates.

Future State Pension System Replacement Rates for Full-Career Workers



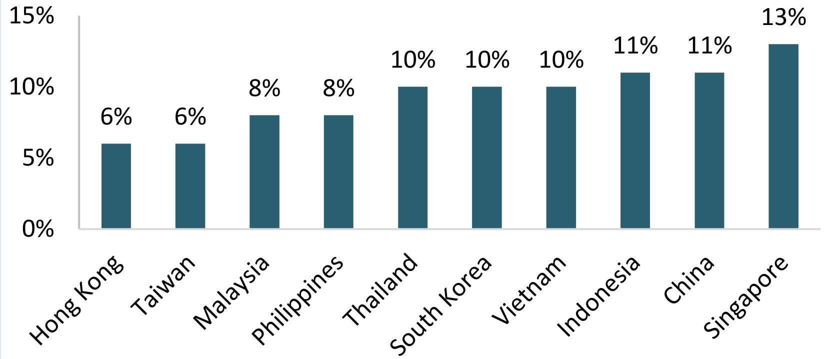
Note: The projections refer to final salary replacement rates for average-earning workers entering the labor force at age twenty around the year 2015 and retiring at their state pension system's standard retirement age. In countries where replacement rates differ by gender, the projections are male-female 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, the JHT; for Malaysia, the EPF; for Mexico, SAR; for South Korea, the National Pension System; and for Thailand, the Old Age Pension System.

Source: Richard Jackson, *Voluntary Pensions in Emerging Markets: New Strategies for Meeting the Retirement Security Challenge* (Alexandria, VA: GAI, 2017)

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

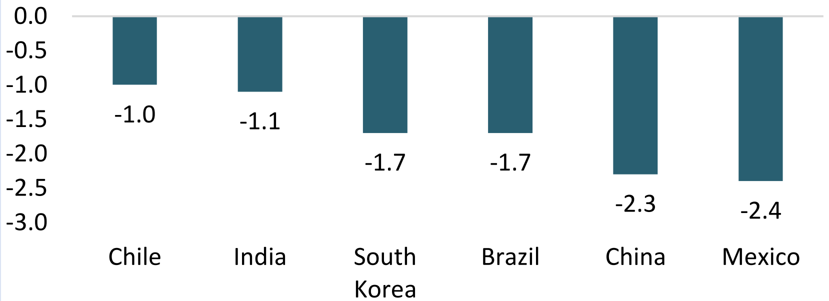
- As today's emerging markets develop and modernize, the expectation that the extended family will assume responsibility for supporting retirees is fading.
- Traditional family support networks, moreover, will soon come under intense new demographic pressure as populations age and family size declines.
- 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.

Share of Respondents Saying "Grown Children or Other Family Members Should be Mostly Responsible for Providing Income 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)

Change in the Average Number of Surviving Children of the Elderly, from 2010-2040



Source: Richard Jackson, Neil Howe, and Tobias Peter, *The Global Aging Preparedness Index: Second Edition* (Washington, DC: CSIS, 2013)

Improving the adequacy of state pension systems may prove to be an elusive goal.

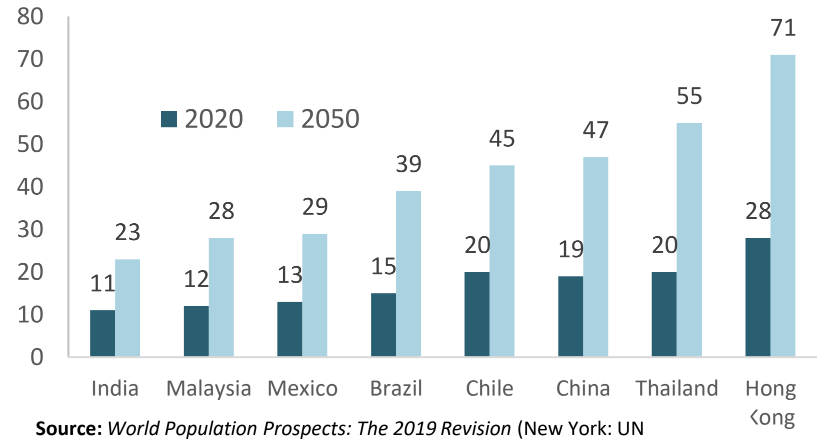
- Most emerging markets have had little success at increasing participation in state pension systems. Indeed, in many emerging markets informality is growing and coverage is declining.

- Given the arithmetic of rising old-age dependency ratios, countries with pay-as-you-go state pension systems have little room to increase the generosity of benefits.

- Countries with funded state pension systems could raise contribution rates—and some, including Chile and Mexico, are doing so. But much of the public views mandatory contributions as a tax and is likely to resist significant increases.

- Although more generous social pensions would help, this is not a long-term solution. It is one thing to have half of the elderly dependent on noncontributory benefits when the elderly comprise 5 percent of the population. It will be another thing entirely when they comprise 25 percent.

Aged Dependency Ratio of Elderly (Aged 65 & Over) per 100 Working-Age Adults (Aged 20-64) in 2020 and 2050



Source: *World Population Prospects: The 2019 Revision* (New York: UN Population Division, 2019)

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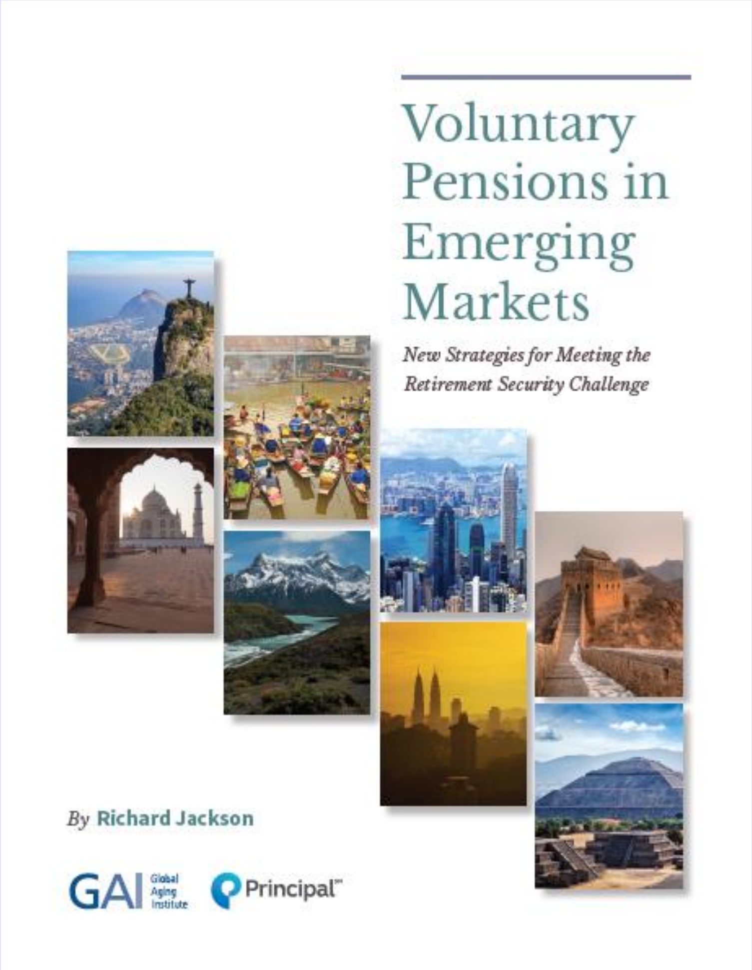
Broadening and deepening voluntary pension systems is an important part of the solution.

- *Common Wisdom:* Expanding voluntary pension systems should be a low priority in societies where mandatory systems cover just a fraction of the workforce.

- *New Thinking:* It is precisely the limited reach of mandatory systems that makes expanding voluntary ones so important.

- *Common Wisdom:* Voluntary pension systems mainly benefit higher-earning workers.

- *New Thinking:* Properly designed, voluntary pension systems can play a crucial role in shoring up the deteriorating retirement income prospects of the middle class. They can also help to improve the retirement security of informal-sector workers.



Today's Voluntary Pension Landscape

Some Good News and Some Bad News

- GAI's report on voluntary pensions 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

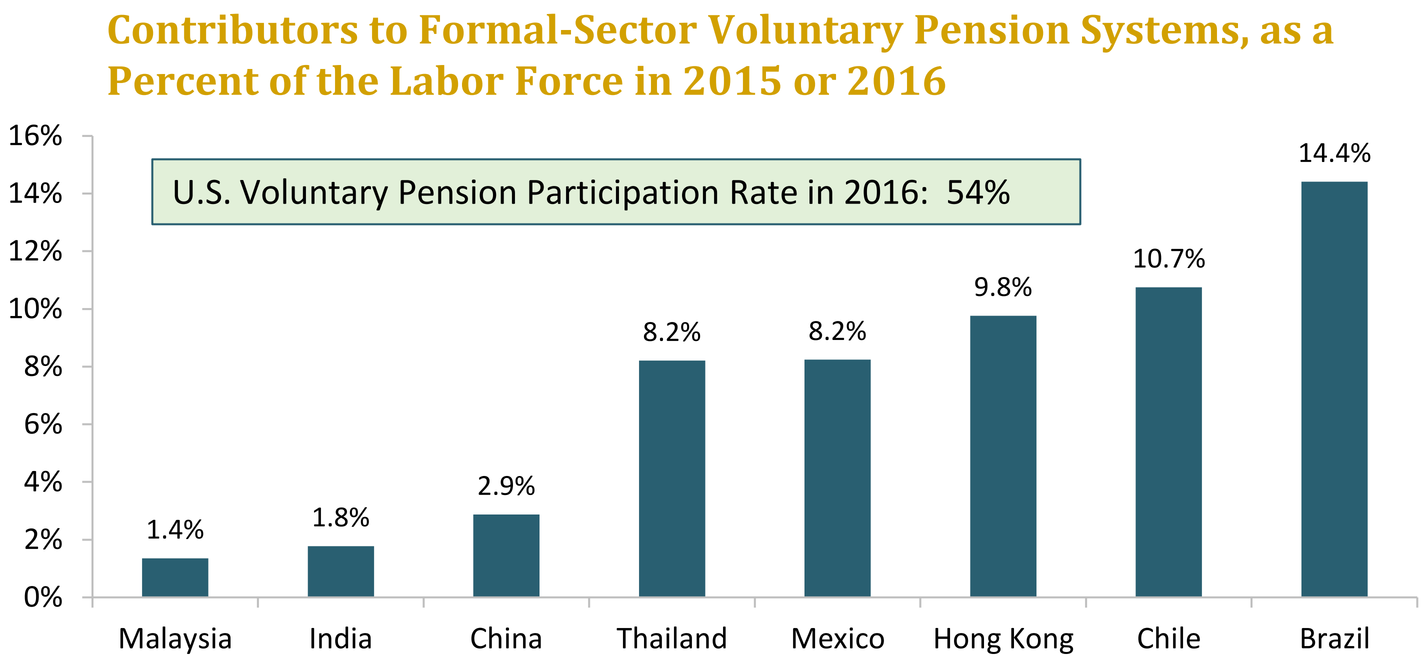
INDIA

MALAYSIA

MEXICO

THAILAND

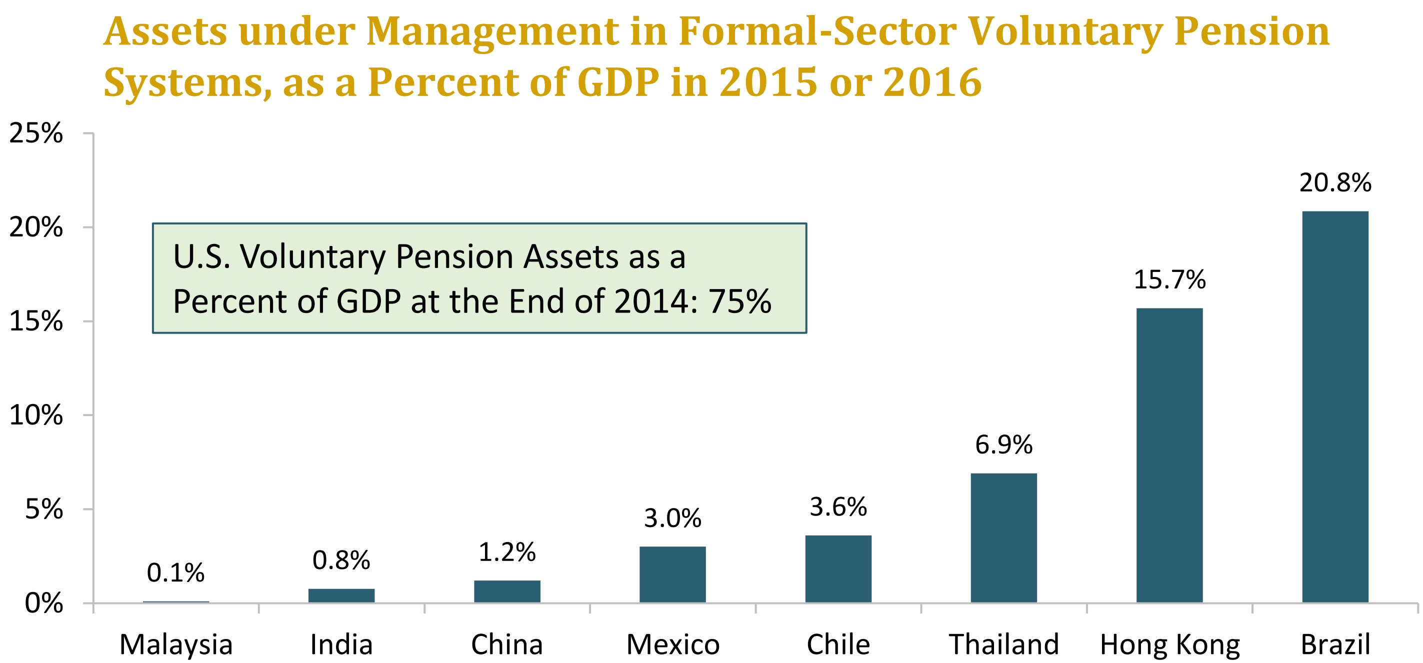
The Limited Reach of Voluntary Pension Systems: Only a small fraction of the workforce participates.



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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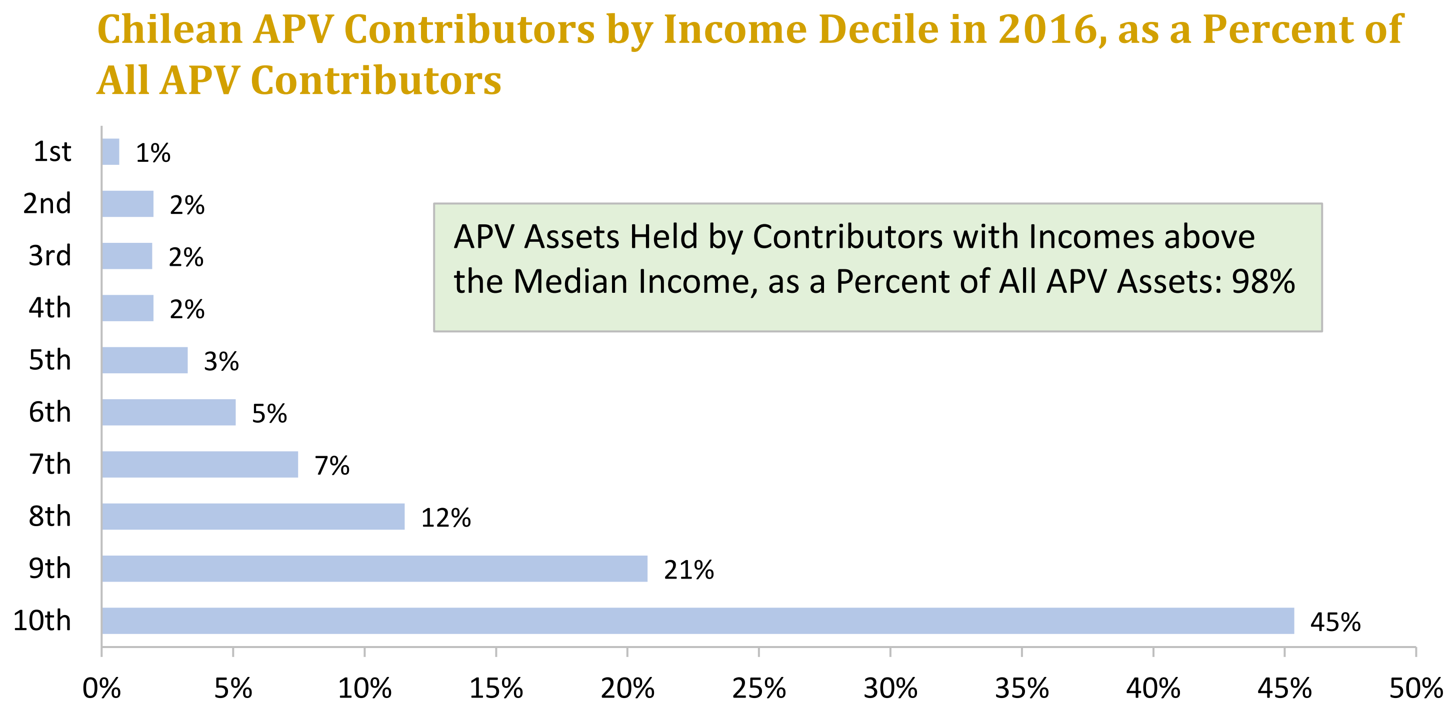
Source: For Brazil, ABRAPP and FenaPrevi; for Chile, the Superintendency of Pensions; for China, WillisTowers Watson, *Global Pension Assets Study 2017* (Arlington, VA: Willis Towers Watson, 2017); for Hong Kong, the MPFA; for India, the NPS Trust and Ministry of Finance; for Malaysia, the PPA; for Mexico, 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.

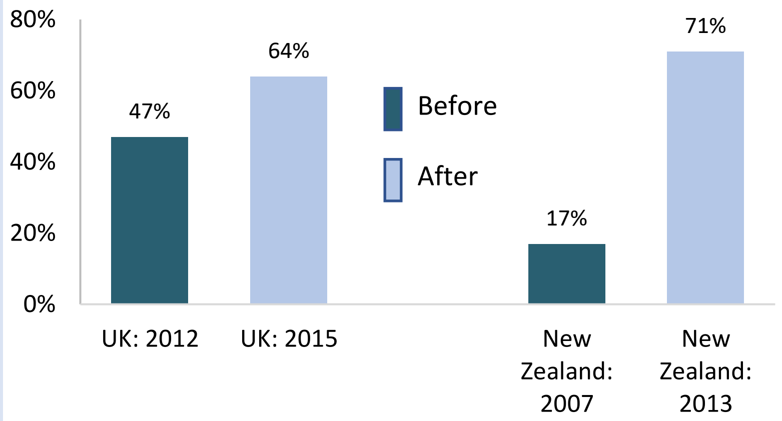
- At a minimum, emerging markets should require employers who sponsor a pension plan to implement autoenrollment. More ambitiously, they could require all employers to sponsor a plan in which their workers would then be autoenrolled.

- 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 the systems' existing voluntary tiers. Those with pay-as-you-go systems could establish voluntary 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

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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/or matching contributions, which tilt the other way.
- Along with automatically enrolling workers in the voluntary tiers of state pension systems, governments should provide generous supplements to their savings.
- 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 some 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 can be 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 should 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**: Fees need to be limited. The best approach is to promote efficiency-enhancing competition among fund managers. Although regulatory caps can be effective, they may distort investment decisions and have unintended and self-defeating consequences.

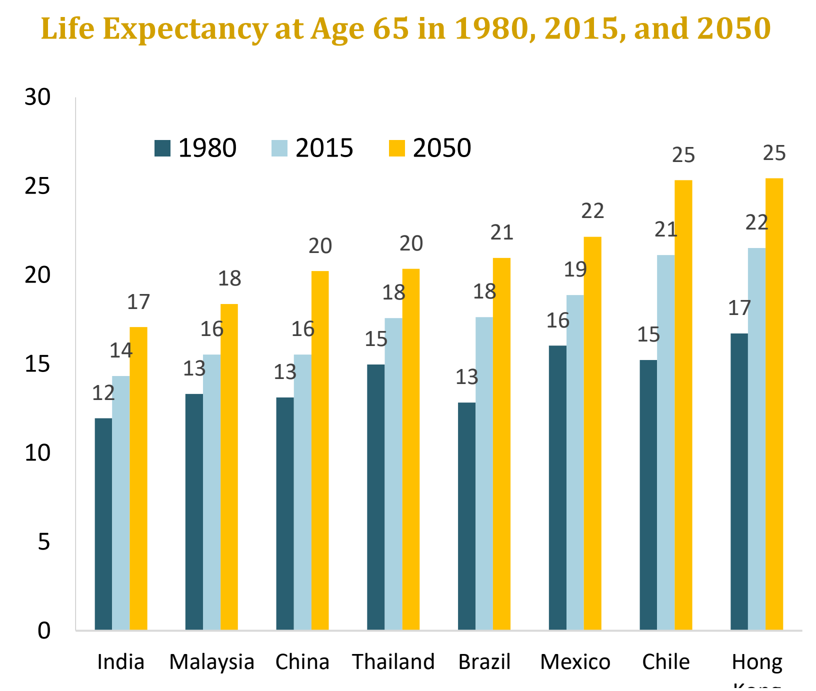
Payout Phase

- 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 GAI's 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 retirement ages, which in some countries are as low as 55, match the needs of their rapidly aging populations.



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

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 often to persuade people to save for the long term. In Latin America, where household savings rates are generally low, it is often 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 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 is more limited in most 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 encourage 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.
- Until recently, the obstacles to extending coverage beyond the formal sector were almost insuperable. However, advances in digital IT, financial inclusion, and national ID systems are opening up new ways to reach informal-sector workers.
- Economic incentives, especially in the form of generous government matches, can play an important role in encouraging the participation of informal-sector workers.
- Considerable flexibility is also needed in the rules for everything from contribution rates to preretirement withdrawals.
- Although it is too soon to gauge the success of most of the new informal-sector pension systems, the results in India are encouraging—and in China they have been nothing short of spectacular.

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