PENSIONS CHALLENGES IN EAST ASIA

Frederic Blanc-Brude, research director, EDHEC-Risk Institute Asia, draws on research supported by AXA Investment Managers to discuss East Asia retirement planning challenges.

While the demographic and investment challenges that characterise retirement planning in East Asia are significant, regulatory changes can go a long way to addressing this.

Demographic trends are difficult to offset or reverse and the rise of lifecycle suggests that in the absence of new sources of income to support the increase of per-capita consumption of the elderly in an ageing society, serious consequences can be expected in terms of either fiscal stability or intergenerational social friction. Crucially, the pace of population ageing leaves little time for adaptation and spreading the cost of the last stage of the demographic transition over several generations.

Likewise, structural financial distortions and macroeconomic imbalances create an investment environment for pension savings in which a number of standard hypotheses of academic finance, such as mean reversion, may not apply for long enough to make horizon-based investment strategies effective. In turn, this may increase the need to invest internationally to offset such distortions. The longer the eventual rebalancing of some of East Asia's main economies takes, the more painful it is likely to be for a generation of savers. As the rebalancing of Japan from the 1990s onwards illustrates, a multi-decade slump can follow a balance-sheet recession, making long-term investment planning difficult. However, the introduction of scientific investment concepts into the design of pension savings plans will only make these issues more explicit and contribute to a necessary regulatory and macro-prudential debate about the future of such fast-ageing societies.

For funded pension systems to deliver levels of real wealth that are commensurate with post-retirement consumption objectives, scientific solutions recommend the combined implementation of three investment paradigms: (i) liability-driven investment or LDI; (ii) lifecycle investment; and (iii) risk-controlled investment or RCI.

Pensions are long-term liabilities that are dynamic and depend on several time-varying factors. Pension solutions should therefore be designed to maximise the likelihood of meeting those liabilities at the horizon. This is the LDI framework.

Furthermore, the investor's horizon needs to be formally taken into account. As they approach retirement, plan members should be exposed to less risk. The strategy, notably the amount of risk-taking, should be dynamic depending on the current wealth and future expected performance, and should explicitly consider the investment horizon. This lifecycle investment dimension is therefore crucial to meet the needs of plan members.

This strategy needs to be implemented while managing risk levels: there need to be short-term constraints too, which take into account the existence of a sponsor when there is one. These constraints can either be self-imposed or defined by the regulator. This is the risk-controlled investment approach.

In this context, several important points can be made regarding the improvement of funded pension plans in East Asia.

Mitigating public pension crises

Large reserves represent a unique opportunity for East Asian governments to address the un-sustainability of public pay-as-you-go pension schemes resulting from population ageing. Fundamental changes should be made to the way reserve funds are controlled and managed, and investment management processes and tools should be adopted to allow pension reserves to achieve what should be their sole objective: supporting the public pension system by minimising the burden of pension liabilities on future generations while ensuring adequate public pension provision.

The main changes required include clearly defining the long-term objectives and short-term constraints of reserve funds, and putting in place the governance mechanisms that guarantee that they only attempt to achieve these objectives while respecting binding constraints.

With well-defined objectives and constraints, adequate scientific investment solutions can be defined and implemented, and, in turn, the sustainability of public pension systems can be greatly improved.

Improving sponsor and member outcomes

Voluntary schemes have not led to a strong corporate pension sector, but instead have become an avatar of the retirement allowance preference that has historically defined East Asian corporate culture. Corporate defined benefit (DB) pensions in East Asia play a role as a source of deferred pay to reward loyal employees and provide long-term incentives to managers, but they do not provide retirement income.

Two types of improvements should be considered for private DB plans in the region.

First, DB plans need to improve their funding levels and volatility in the context of more stringent regulation and the need to minimise demands on the sponsor since higher contributions may not be economically feasible. The simple application of asset-liability management models, although it allows for capital preservation and frees up a risk budget to improve profitability, would not be optimal for an occupational DB fund backed by a sponsor. Asset-liability management models should explicitly account for the implicit guarantee of the sponsor, and recognise that the risk of the guarantee depends on the health of the sponsor.

In this context, short-term funding ratio constraints would not be costly for pension funds if they were not reluctant to implement risk-management strategies that are optimal given such constraints. Smarter surplus sharing rules should be encouraged. Giving plan members access to part of the surplus will encourage more risk-taking, which is typically in the interest of the sponsor, while imposing a cap on the terminal funding ratio can allow the purchase of downside insurance and improve the safety of the investment strategy.

Second, since the immense majority of East Asia's DB funds only pay a lump sum, longevity and most inflation risk remains with members, making private DB plans a crude type of hybrid plan. Along with the surplus-sharing suggested above, greater risk-sharing between plan members and sponsors during the post-retirement period can be envisaged even though it may require regulatory intervention to be possible. The development of mandatory annuitisation as already proposed in Singapore, along with financial contracts for managing sponsors' longevity risk, are amongst the solutions requiring future developments of East Asia's financial sector and markets.

Developing defined contribution plans into attractive savings vehicles

Defined contribution (DC) plans leave most risks with individuals but are expected to create incentives both to save and to help manage these savings to meet lifecycle consumption objectives. Since East Asia already has very high household and domestic savings rates, the key issue is creating incentives to save into dedicated pension schemes that are designed to support post-retirement consumption objectives.

However, East Asia's DC schemes create few if any incentives to use them instead of regular savings accounts. They also fail to offer much in the way of post-retirement investment solutions that would justify channelling existing savings into such accounts. When plans are voluntary, incentives are limited because employees are either not allowed or not incentivised to save in DC plans. Employers are also given scant tax incentives to choose this option. Mandatory DC schemes may also have vesting and portability issues and contribution compliance is variable in some jurisdictions. Contribution ceilings can also be set very low and minimise the use of such plans.

Like DB plans in East Asia, DC schemes seldom offer any post-retirement income but instead pay a lump sum. Hence, an important issue is to incentivise the use of DC plans by creating clear and adequate incentives to use them. These solutions should take a long-term objective into account (for example, target wealth) and allow for an ALM approach while taking investment horizons into account (lifecycling). They should also make the best use of low-cost investment solutions using optimally designed building blocks. Standardised packages should further reduce complexity and costs. Finally, regulated defaults should be designed with these criteria in mind.

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