

# Climate change

## Asian pensions

In a roundtable discussion forum sponsored by Deutsche Bank, industry leaders discuss matters such as the changes occurring in the Asian pensions market, tax issues, rates of expansion and the development of capital markets across Asia

*Life & Pensions* What are the main drivers for change in the Asian pensions market?

**Bob Charles** In terms of the way the pension legislation is changing and the way that people are thinking about pensions, my take on this is that everybody – governments, employees, media – understands that there is a problem. Demographics is a part of it, as is simple under-provision and the fact that most countries in Asia are getting richer and are therefore thinking more about pensions. The problem is who pays for it and that is where nobody is putting up their hand. Governments throughout the region understand that there is a problem but they look to pension systems in the US and in continental Europe in particular and say very clearly “we don’t want to do that”. I think we will see, particularly in places like China and Vietnam – former socialist countries – that social security will continue to be important, but this is the exception, rather than the rule. It will be developed but I think it will be more targeted, at very low incomes. I think there will be a continuing debate in Hong Kong about whether social security here should be increased – we won’t mean social security in the same way that Americans mean social security. My take on this is a little bit pessimistic to be honest. There is a very clear need for more focus on retirement saving in Asia but I think we need to be realistic about who’s going to pay for it – I don’t see a lot of people stepping forward at the moment.

**Wayne Edelist** I think it is important to consider the question of pension development in Asia from a historical perspective. If we look at the development of pensions systems in Australia, Canada, or the UK, for example, they were part of the development of a welfare state post the industrialisation of those countries. Workplace pension plans, for example, have always preceded the development of state pension systems, which are a very recent innovation – the UK and Canada,



for example, have systems that are only 50 to 80 years old. In Asia, however, social security systems are younger, so increasing coverage ratios will be a driver, particularly in light of the ageing demographic. That’s going to be a key concern for governments, which we believe will drive the legislative pensions agenda. The evolution of existing systems is also going to be key. Asia’s pension systems are continuing to evolve in terms of risk controls, returns and diversification. As this continues, it will have a major ripple effect both on benefit provision and the way pension assets are invested. This will, of course, take time.

**Roger Steel** There are a lot of positive drivers but there are a lot of constraints such as serious ageing issues, particularly in places like Korea. The other thing that is happening is changing social patterns. Traditionally in Asia, particularly in the

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Chinese community, children used to care for their parents for a long period of time. That pattern is progressively changing – there is less interest from younger people in doing that. People are increasingly aware that they are probably going to have to look after themselves as they get older, and governments are aware that they will have to do something to provide for these people. Coupled with that, there are rising living standards. If you look back 20 or 30 years, people did not worry too much about this, not only because their children were going to look after them, but because they were resigned to living in a very small space and didn't have very high expectations. Now that living standards are going up, people are aware that they need money for retirement. These are the positive factors, but you've got some big constraints. In addition to what Bob mentioned, you've also got some big issues with tax. Generally in Asia, and particularly in Hong Kong, there is limited tax incentive for anyone to save for retirement so, unless you put a negative tax on retirement savings, how do you incentivise people?

*Life & Pensions:* Is the tax issue as consistent across Asia?

**Patrice Conxicoeur** No, I don't think Hong Kong is a unique case where tax incentives are either lacking or inadequate. If you look at the launch of the defined contribution (DC) schemes in Japan, for instance, the amount of tax incentive they are getting receiving is pitiful.

**Carolyn Butler** Yes, but I query that. Why do you want tax incentives in a very low tax régime? The advantage we have is a very low tax régime in Hong Kong, so it's almost counterproductive to then say you need taxes to promote retirement



savings as the low level of tax is a reason why businesses comes here.

**Alan Merten** The tax issue is only part of the solution – Australia has had a mandatory pension superannuation system for over 20 years now and now has triple the population of Hong Kong but 20 times the level of savings in that system. Interestingly, it's not unusual in Australia for a couple to retire with A\$150,000 in their superannuation account at retirement, but owning a house that is worth three to four times that. Therefore, the main retirement savings vehicle in Australia is not a tax-advantaged pension system – it's a slightly tax-advantaged property investment system. Australia has a very complicated tax system compared with a number of other countries in Asia, and certainly relative to Hong Kong. I'm not advocating tax by any means, but the pension scheme is supported 1) by mandating a reasonable contribution level and 2) by tax incentives that drive a whole lot of other things like a financial planning industry that doesn't exist in Hong Kong.

*Life & Pensions* There are clearly still major barriers to expanding pension provision in the broader Asian market but how quickly is it currently expanding?

**Patrice Conxicoeur** If you look at the market in the region from a provider's perspective, I think the rate we're estimating is somewhere in the region of 9.5% to – 10% per annum growth. There are countries around the region, such as South Korea where the rate of growth is around 20%. The main thing is to target the wealthy and the upper income bracket. In many ways that is easier – they are going to be consumers of more sophisticated, higher higher-margin products, etc. It sounds like a wonderful business plan. A very large share of the volume is in middle and low income – what is really missing here are three things that need to come together: a government framework; plus this framework needs to allow the private sector to step in and provide services, which is not always the case – think of India for instance – and, thirdly, we need a modicum of education, which is sorely lacking where people have bigger worries. We also need more developed financial markets. One thing that strikes me is that saving for retirement without bonds is difficult. Look at the underdevelopment of the bond markets around the region – it's unhelpful.



Raymond Cheung

**Carolyn Butler** It's difficult to develop a bond market when you have very few companies in these emerging economies that would be rated sufficiently high enough for you to be investing your potential pension money for the next 20 years.

**Patrice Conxioeur** I think it brings us squarely back into the legal and governance framework. The Chinese bond market has been stifled by regulation for years.

**Roger Steel** And Asian governments are running surpluses so they're not raising money and issuing bonds either.

**Wayne Edelist** We should remember that Asia's local currency bond markets are young, however, they are continuing to develop. Compare the raft of local currency bond issuance seen since the start of the year with low volumes in the G3 bond market, for example. However, for now, the need for longer-dated paper can always be met from outside the region, which Asian investors can access via a range of investment products. We're seeing increasing willingness to change on the part of financial institutions; to recognise that, if they are allowed to reduce their return by a little bit in exchange for eliminating the possibility of a very large drop, that's a good thing. Using derivatives intelligently to limit downside risk also helps to close the gap on the fact that there is no long-dated bond market. Derivatives products, when designed intelligently and allowed to be sold, can also help compensate for other financial instruments that may not be available in Asia by providing exposure to longer-dated assets from other markets.

**Patrice Conxioeur** I'd like to highlight one phrase you use, which is "allowed to sell" – there is no shortage of technical solutions, but to pick on the Hong Kong system for a second, the way the rules are designed in the Mandatory Provident Fund (MPF) as far as derivatives are concerned are too restrictive. If you are a 20 year old and you're saving for the next 40 years, you don't need protection whatsoever – you should be allowed to take as much risk as possible. On the other hand, if you are closer to retirement, you cannot afford a market crash and you need exposure (for upside) with protections – including derivatives.

**Alan Merten** But, even if you do want equities, you cannot invest significantly in emerging equities and, over a long time frame, that should be a reasonable part of a diversified international equities portfolio.

**Sally Wong** But that is not unique to Hong Kong. If you look at different governments within the region there is a general tendency to be over conservative. The discussion about investment for pensions is very politically tainted. It involves a whole spectrum of stakeholder groups and the system always ends up being a political compromise. The outcomes often tend to err on the side of caution and, if you look at the different frameworks, there is a lot of restriction in terms of the type of asset classes or geographical lines that you can cross. This highlights the importance of education; we have to work jointly with authorities to educate the community that the greatest risk is not short-term volatility but being too conservative and failing to achieve an outcome that can outperform inflation and, thus, not being able to save sufficiently for the long term. I think this is a very key message – the industry and regulators have to educate the community.

**Life & Pensions** Capital markets in Asia are clearly developing – but which are the most interesting parts of this sector?

**Wayne Edelist** I would say the variable annuity market is at a very interesting point right now. The second-largest variable annuity market in the world, after the US, is Japan, with assets growing from 0 to \$120 billion in just eight years. Right now, Korea has about \$30–\$40 billion, as does Taiwan, and Hong Kong a little bit less. We really feel that we're at the base of that curve about to really ramp up. People are experimenting with different types of guarantees such as guaranteed minimum withdrawal benefits for life. These products actually fit the bill of what we're all talking about in many ways – they do provide people with a guarantee on their investment that should they die in the first 10 years, then they'll get all their money back and, if you survive that period, it will be worth at least 20% more of what you put in and so on.

**Alan Merten** Manulife has launched in Japan and it's the same story – very



Patrice Conxioeur

successful. It has also launched in Hong Kong and in Singapore and these products do address some of these issues. The interesting thing is, going back to the conservatism of governments and the politics – the good news is that risk is passed to the insurer or financial institution, but then it goes to the question of the strength of the regulation locally. A range of different régimes are in place, different controls and, even in the most developed markets, it is difficult for the consumer to tell that business 'a' is a good one to do business with and business 'b' is not necessarily someone you want to trust your money with.

*Life & Pensions* How far away are we from seeing widespread variable annuity products that can be hedged and risk-managed in local currency?

**Wayne Edelist** In some ways not so far at all and, in others, a fair bit. In the case where the customer is guaranteed a certain amount of accumulation and/or a certain benefit upon death, these products are of shorter duration and can be handled fairly well in the current set-up. Where Asia's lack of developed yield curves constrains the local currency offering is in the case of a guarantee withdrawal or income stream. Since these products can have an expected duration of decades, it is difficult to find assets like maturities with which to match them. Another aspect to consider is whether the local currency value is continuously guaranteed, or just at the end-point. The former requires more hedging and is more expensive, as things currently stand.

**Raymond Cheung** Maybe Alan or Roger can give me some idea of why Hong Kong is not successful yet in acknowledging traditional annuities. Is it because they cannot offer attractive incentives to the distribution channels?

**Alan Merten** No, absolutely not. The distribution channels certainly demand attractive compensation and for the right sort of business this is not a block for the insurers or consumer value. People with the wealth to make it interesting to do this say: "I can do better investing in individual stocks on the Hong Kong stock market".

**Roger Steel** That's global. If you look at most regimes where real annuities have been sold, there has been some kind of requirement that you have to do it. Let's face it, if we were told we could have a lump sum at 65 and do whatever we want with it or we had to lock it up and draw it down drip-feed – what would you do? It's just human nature. I think the absence of a mandated system is a bit strange – the MPF in Hong Kong, for example – all this money supposedly saved for retirement. I think there will be a lot of 65 year olds at the Venetian in Macao on the day after their [65th] birthday.

**Carolyn Butler** Bear in mind that the government here has traditionally tried not to be interventionist. There is a traditional culture of 'people can look after themselves'. Taking aside one area of the community that probably does need attention, that has generally been the case in the past. To try first to mandate that you need to have compulsory retirement savings; then how you receive it is an even bigger anathema to Hong Kong people. There's a tax issue because an



Carolyn Butler

annuity is taxless income – a lump sum is not taxed. It's completely countercyclical, or counterintuitive. Possibly the insurance companies have come out with a smart way of calling something an investment rather than an annuity now that it's no longer taxed.

**Roger Steel** I think it will change. If you look, for example, at MPF – nobody really worries about it now because people who are leaving the MPF system now have got relatively small balances. If you look at other countries – you mentioned Australia before – for a long time in Australia you were able to take your money out of superannuation in a lump sum. When it got big enough, significant enough, the government unfortunately said 'OK, you can only draw it down over time'. As the sums in pension schemes get larger, we will see governments changing.

**Bob Charles** This aversion to annuities is nothing to do with Asia. People worldwide underestimate how much it costs to provide an annuity. There's no point in governments getting concerned about pensions on the basis that they want people to avoid poverty in old age. People simply save for mid-old age rather than extreme-old age. Five years ago the EPF in Malaysia introduced an initiative where they gave people the option of putting their contributions – this is a mandatory nationwide DC system - into a genuine annuity product with an insurance company. There was a huge brouhaha in the press because the insurance companies that sold these products were crucified for providing rip-off products – you give this money, you lose it if you die. The levels of commission on distribution were relatively modest but, because the premiums were quite high they were seen as daylight robbery. From a sales point of view, it was a disaster, despite the real financial reality was that the products were extremely good value and the insurance companies that have sold many of them are now technically insolvent because they were selling them too cheaply. Learning from that, earlier this year the Singapore Central Provident Fund (CPF) put forward an initiative that will start in the next four years. At retirement you have to pay one-quarter of your account balance as a premium. The remaining three-quarters is drawn down over a period of time, say 20 years, but ultimately that's exhausted.



Alan Merten

At retirement, the balance of the account is used as a premium that is held by the CPF, so the CPF acts as an insurance company and provides you with a pension for the rest of your life. It's a clever scheme because it means that there is genuine longevity insurance, but the redistribution between those who die early and those who don't is much less extreme than under a conventional annuity. Learning from the experience in Malaysia, the way that it is being marketed to the CPF members is that you do get your money back if you die – the premium has a contingent assurance element. I'm not necessarily saying that governments around the region are going to copy that; that they want to act as a mega insurance company and take on longevity risk, but I think we will see that as a model in terms of insisting that, if governments are going to give tax incentives, they get something back in terms of making sure that people are protecting themselves for the long term.

**Patrice Conxicoeur** It goes back to education for governments as well. With the CPF in Singapore the government is explicitly underwriting the longevity risk because the reality is that every single government in the region is stuck with it anyway.

*Life & Pensions:* So you're saying that governments across the region are all going to have to take longevity onto their balance sheets in the longer term?

**Patrice Conxicoeur** I would say the government in Singapore is the only one being realistic about it.

**Raymond Cheung** I want to add something to the point about annuity. I personally feel quite foolish with regard to this product. In 1984, when I was working with a UK firm, I tried to introduce products called Qualifying Policy into Hong Kong. This is a product that is tax-efficient for people in the UK. I modified it to add a lot of fund choices to it and to reduce charges. Then they became the most popular products in Hong Kong in the last 10 years. Basically, if annuities can be properly packaged can be a good product to sell in Hong Kong.

*Life & Pensions* Fees in state-operated pensions systems in Europe are as low as 0.14%, but as much as 2.5% in the MPF. Is this justified?

**Sally Wong** Moving forward, it's a major challenge for the industry as to how to ensure that these discussions about fees and charges are put into context. At present, it seems that the discussions have been too fixated on fees, but for employees to make informed choices, they have to consider other key aspects – the volatility, return and services, which are equally, if not more, important than fees. An integrated approach to consider all these key aspects is vital if member choice is to be really meaningful. Of course, another aspect that we have been focusing on is investment restrictions – how to ensure there is greater flexibility in the investment arena to enable providers to structure a sufficiently broad range of products to facilitate employee choice. These are the key areas that the government should focus on in order to improve the system in the best interests of the employees

**Bob Charles** I disagree with Sally on this. I think consumer bodies in Hong Kong are absolutely right to be focusing on fees. The whole issue about how do we get people to focus on the need to save for retirement – if we're not starting from a market that is pretty price competitive, I don't think you can have a successful pension system.

**Carolyn Butler** I'm going to take the middle ground and argue with you both on this. I would argue that the Australian system is much more complex because of the taxation system. This means that, in theory, the administrative costs of the Australian system should be higher than Hong Kong. On the other hand, you have a much more robust payroll and contribution capture system than you do in Hong Kong. Bearing in mind that many employers in Hong Kong have 10 employees and manual payrolls, costs should in theory be higher. My concern with the focus on fees is that both the individual receiving the return and the government itself is not focusing on what causes fees to be high. Regulation is the number-one issue. Then, we have the government saying "fees are too high and now we need to give additional



Sally Wong

employee investment choice” but with extended employee choice the pension market/product looks closer to a higher cost retail product. On the other hand, I do think that there was probably a higher fee level built into the system during its infancy because a lot of money was spent by suppliers for pension market entry to begin with. I’m sure they’ve recouped these costs now and, although there may be an argument for lower fees going forward, suppliers also look at this as a long-term business they can make some money out of.

**Alan Merten** And adding to Carolyn’s comments, you need to ensure that you are comparing apples with apples. When you quote a fee of 0.14% you need to compare it with an appropriate alternative here. Carolyn mentioned regulation and administration but, for the full service providers at the higher-fee end, there is also distribution, servicing and a variety of functions, not just asset management.

#### *Life & Pensions* Inflation?

**Wayne Edelist** It is absolutely coming to the fore. It’s one of the major trends we’re going to see. I would say that this is, perhaps, something that Asia as a region can learn from. Some of the best schemes in Australia, New Zealand and Canada are aggressive at purchasing infrastructure assets in order to combat inflation. We’re adding a billion people a decade to the planet and there has been a large amount of poverty reduction in Asia, with larger numbers of people now wanting to have a motorcycle, a mobile phone or to eat more protein, which is fair and everybody deserves that. We are definitely seeing an interest and, because those inflation assets don’t necessarily exist right now in Asia but do exist in UK and other parts of the world, how we can swap or quanto those hedges for people out here is something that people need to consider at both the retail and institutional level going forward. Even if you have a guarantee that you’re going to get \$150 back for every \$100 you put in, what will that \$150 buy you when we get to 2018?

**Patrice Conxicoeur** I would second this view. We have been active in the inflation bond market for about 10 years as managers of products and we’ve been talking about this to institutions around the region for about five years. I think it’s an understatement to say that at the beginning of those five years we were literally preaching in the desert. There has been a very noticeable change in the last year or so – not only do we have an audience, we have a very interested audience.

*Life & Pensions* How optimistic are you that Asian countries can overcome the challenges posed by pension provision?

**Raymond Cheung** I can only speak for Hong Kong’s perspective. First of all, I’m very bullish on this pension market in Hong Kong. Product-wise, I personally feel that, if I can get some creative annuity products, I’ll be very happy to promote them. I think there is good opportunity and potential ahead for the providers.



*Roger Steel*

**Sally Wong** In general, I’m very positive about future development within the region. I think there’s a general awareness about the challenges posed by the demographic trends and the importance of developing a sustainable system and the governments are very keen to develop an optimal mix among the different pillars, in particular to leverage more on the second and third pillars. I think private sector players like fund managers, insurance companies and all those can play a very important role in helping governments in the region to develop an optimal model to capitalise on the growth of the global capital markets and private sector expertise and resources. When we talk to regulators, they try to seek input from us as to what sort of structure should be in place with regard to governance, investment restrictions, players and market entry. I think they really need input from the industry, especially the experience of other countries, to help them build up the infrastructure. These dialogues provide an excellent opportunity for players to share their experiences in other markets, to help develop solutions that can help the governments to come up with solutions to tackle the increasing burden posed by an ageing population. I am 100% bullish about the opportunities in the region.

**Roger Steel** Overall, I’m very optimistic. The only bugbear we’ve got in the system is politics. There is so much momentum, but it has to be driven by governments. Even in places where we have debates about whether or not we’ve got democracy and how far it goes, etc., the perverse thing is that if I make a brave comment here in Hong Kong, we have an even more democratic system than anywhere else in the world because the government feels it has to keep everybody happy. If you go to a conventional democracy, they know they only have to keep 50% plus one happy to get re-elected, but you have to keep everybody happy here. That makes progress potentially slow. If you go to the other extreme, some places in Asia – a well-known city some miles south of here – they don’t need to keep anybody happy, they just have to do what is right for them. The drivers and the government will be there, but the question is how to move forward keeping people happy in an environment where people very much want individual, personal control – in Hong Kong, say. Fundamentally, we’ve got to be optimistic. I think we’re going to see huge growth in pension assets in Asia over the next 10–20 years and ongoing.