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# Pension Fund Reforms for Asia

Capacity-Building Workshop, 9-13 November 1999, Singapore

Executive Summary of Proceedings

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## Macroview

[¶ ] References are to paragraphs

Developing countries in general and Asia in particular are aging rapidly. As a natural consequence there will have to be significant increases in public social spending. With modern economic development, traditional or village family support systems are being increasingly replaced by government pension schemes for old age support. Pensions are unique financial instruments that aim to deliver affordable, reliable benefits far into the future. Their key feature is that they are long-term intergenerational contracts for old age consumption. **[¶ 5, 6, 25]**

Right now, Asia is at a crossroads of pension reform. Many countries have only adopted **parametric or marginal reforms** to tackle their growing pension problems. These reforms usually include decreasing the replacement rate, increasing the contribution rate, or raising the retirement age. But such reforms are politically difficult and, more fundamentally, often do not produce benefits such as long-term savings increase and financial market development that would occur with full funding. **[¶ 15, 22]**

Pension reforms also require **capital market development**. There is a symbiotic relationship between pension reforms on one hand and financial development on the other. They are mutually interdependent and help reinforce the development of each other. **[¶ 58]**

Generally, pension systems should move in the direction **of defined contribution (DC), funded, and competitively-managed systems**. A DC system is desirable because it links benefits closely to contributions, discourages evasion and early retirement, avoids hidden redistribution, and promotes labor mobility due to portability. A funded system is preferable because it avoids unrealistic benefit promises, applies higher taxes as the population ages and intergenerational transfers, while at the same time promotes saving. And a competitively-managed system is advantageous because it bases investment decisions on economic rather than political criteria, allows for the highest return on savings and the highest productivity of capital, reduces risk through diversification, and promotes the development of financial markets. **[¶ 20]**

**To strengthen the institutions** to support pension reforms, the first step is to make old-age income support systems credible by clearly outlining the objectives of the retirement system and making only those promises that can be reasonably kept. The second step is to reform the tax system since most pension systems rely on taxes for revenue. The third step is to reform the financial infrastructure. The importance of this can be seen, for example, by the inability of weak banks to properly evaluate and monitor long-run projects. The fourth step is to reform the labor market, in particular high tax rates and unaffordable benefits that threaten the labor market. The fifth step is to adopt a flexible monetary policy. Sound monetary policy is key to public confidence in a government's economic management. **[¶ 28]**

A large majority of Asians remain outside the formal social security systems. Pension reforms in Asia need to **expand coverage** to include a larger segment of the population. Furthermore, there is an urgent need to change the mindset of the public and the policymakers so that they understand that pension management is an important and integral element of economic management and overall economic performance. A major concern continues to be the low and variable replacement ratios. **[¶ 39, 40]**

The basics of **pension fund management** involve three key phases. The first – the determination of an investment strategy – requires developing investment objectives and strategy, and developing an implementation strategy. The second – the implementation of the strategy – involves defining management and administration needs and selection criteria, selecting managers and custodians, transferring assets and funding the plan. The third – monitoring the strategy and structure – involves comparing results with expectations and objectives. In many developing countries, however, the first phase is skipped altogether, resulting in sub-optimal outcomes. **[¶ 48]**

A country with a pay-as-you-go pension system needs to make the difficult transition to a funded system if it wishes to build capital markets with private pension funds as they have done in many developed countries, or in Chile. **[¶ 51]**

**Japanese pension funds** and financial markets have traditionally been heavily regulated to protect the interests of employees. However, the cost of such protection and regulation has been low rates of return relative to countries with more competitive financial and mobile labor markets. Consequently, greater deregulation and liberalization of the pension fund management industry is called for. **[¶ 78]**

The challenges **People's Republic of China (PRC)** faces in the area of pension reforms are threefold. First, how should it finance the transition to a partially-funded system? Second, how should it invest the funds more productively? Third, how should it expand and unify the system? These three issues are inter-related and resolving them in a satisfactory manner will have a crucial bearing on PRC's economic growth for the future. **[¶ 88]**

The new Mandatory Provident Fund (MPF), a privately managed DC employment-based retirement system, is expected to have a big impact on the broadening and deepening of **Hong Kong, China's** capital markets in the coming years. **[¶ 95, 97]**

**Southeast Asian countries** have the following problems in common. National provident and pension funds do not enjoy functional autonomy. There is also a serious structural defect in the substantial mismatches between assets and liabilities. In the absence of financial market development, provision of adequate replacement rates to members is unlikely. Furthermore, retirement withdrawals are predominantly in the form of lump sums, as opposed to periodic payments, and there is scope for cost improvements in housekeeping functions. **[¶ 93]**

There are five main challenges for **Korea's social security system**. First, income support for the elderly poor must be provided. Second, the scope of the National Pension Scheme (NPS) and the retirement allowance scheme must be aligned (e.g. make the earnings-related part of NPS voluntary). Third, retirement allowances, which are currently largely underfunded, need to become fully funded over time. Fourth, the financial sustainability of "occupational" schemes has to be improved. Fifth, NPS's large reserve fund has to be better managed, primarily by limiting government access and improving the governance structure and asset management. If Korea moved toward a decentralized multi-pillar system, this could create a win-win situation socially, financially and economically. **[¶ 100, 101]**

Across the region, the key question is: **How can pension systems do better**? This is intricately connected with pension management and governance, which consists of four main areas: legal structure, reporting and disclosure, performance benchmarks and evaluation, and asset management. In terms of the legal structure, there is a need to minimize conflicts of interest, clearly delineate participant rights, and follow the *prudent person rule*, which basically means that managers must invest in the best interest of all participants. **[¶ 68]**

Demographic trends and globalization are forcing Asian countries to move toward more formal social safety nets. They need to strengthen their institutional capacity to design and implement social safety net programs, including pension reforms. In order to achieve this, however, policymakers and the general public of East Asia would need to undergo two important changes in their collective mindset. First, they should regard social protection policies as an integral part of economic management in this age of globalization. Second, they might reconsider socio-economic information as a public good, rather than as a strategic resource to be used for national advantage. **[¶ 122, 123]**

Special provisions are also urgently required for women who have not worked enough to be eligible for protection since they represent the largest uncovered and hence most vulnerable group in the population. **[¶ 127]**

The **overall pension reform objective** should be to balance social equity with efficiency considerations, while avoiding fiscal unsustainability and trying to support mutually complementary capital market development. In practice, this requires a move to a three-pillar system consisting of (i) minimum social assistance, (ii) mandatory funded DC component, and (iii) voluntary funded DC component. As usual, the pace and sequencing of reform would have to vary from country to country. **[¶ 132]**

Pension reform is not a panacea for all economic problems, but it is essential for maintaining competitiveness in the increasingly globalized world economy. Pension reform's positive impact on fiscal sustainability and financial market development is particularly significant in this connection. Of course, pension reform is also a difficult and complicated process that requires a 'systems approach' to integrate legal, fiscal, financial, social and other aspects. In this connection, the importance of a carefully planned and well thought-out sequencing for reform in Asia cannot be overstated. **[¶ 140]**

## Introduction

**1.** The Workshop on Pension Fund Reforms in Asia was held at the Plaza Parkroyal Hotel in Singapore from 9 to 13 November 1999. It was jointly sponsored by the **Asian Development Bank (ADB) Institute, the Technical Cooperation Directorate (TCD) of the Ministry of Foreign Affairs (MFA), Singapore and the Colombo Plan Secretariat (CPS)** and was attended by senior and middle-level officials from government agencies in charge of pension funds. The participants came from Indonesia, Korea, Malaysia, Papua New Guinea, People's Republic of China (PRC), Philippines, Singapore, Thailand, Tonga, and Viet Nam.

**2.** Resource speakers for the Workshop included experts from international organizations such as the Asian Development Bank and the World Bank; major regional and U.S. universities such as the Wharton School, University of Pennsylvania, Sophia University (Tokyo) and National University of Singapore (NUS); pension fund management companies; and Hong Kong, China's National Provident Fund. They made presentations on the basic principles and current issues in pension reforms. There was also active interaction among the presenters and participants. The participants were organized into three breakout groups that discussed country reports prepared by the participants. Three presenters led the breakout groups in their discussions.

**3.** The main topics covered in the Workshop included the following:

- Alternative Approaches to Pension System Reforms
- Pension Reforms in Asia: Policy Design and Implementation Issues
- Pension Fund Management and Financial Market Development
- Country Experiences of Reform – Japan, People's Republic of China, Singapore; Hong Kong, China; Korea and Kazakhstan
- Pension Fund Management: Performance, Governance and Regulation
- Pension Reforms – Implications for Poverty and Social Safety Nets
- The Role of Multilateral Institutions in Promoting Pension Reforms in Asia

**4.** **Mr. Anthony Chng Chye Tong**, Director, TCD, and **Mr. Akira Murata**, Director, Program for Public Administration, CPS gave their welcome remarks. **Dr. Masaru Yoshitomi**, Dean, ADB Institute, opened the proceedings by emphasizing the urgency of fiscally-sustainable and growth-promoting pension reforms in a rapidly aging Asia. **Dr. Raj Chhikara**, Senior Capacity Building Specialist, ADB Institute, oriented the participants about the overall organization of the workshop.

## System Reform Alternatives

**5.** **Dr. Estelle James**, Lead Economist, Development Economics Research Group, World Bank, began her presentation on **Alternative Approaches to Pension System Reforms** by noting that the proportion of global population over 60 will almost double by 2030, from 9 percent to 16 percent. In particular, developing countries in general and Asia in particular are aging rapidly. Global aging is driven by falling fertility and rising longevity.

**6.** A natural consequence of aging populations is a significant increase in public spending. With economic development, family support systems are increasingly replaced by government systems for old age support. Although public pensions take up a relatively small proportion of GDP in Asia, this will rise quickly unless pension systems are reformed. This trend, in turn, will adversely affect the ability of governments to make much-needed investments in health, education and other public goods.

**7.** Old age security affects the entire economy due to the large amounts of resources involved. Among other things, it influences people's incentives to work, employers' willingness to hire workers, the allocation of labor between the formal and informal sectors, level of national savings and their allocation, financial market development, and spending on education and other public goods. The upshot is that old age security affects the productivity of labor and the level of GNP.

**8.** Dr. James organized her presentation around four basic themes: the problems of existing pension systems, how and why countries have been reforming pension fund systems, the relevance of pension reforms to Asia, and the dominance of the family system and other informal support systems for providing old age security in Asia.

**9.** In the West, most pension systems are pay-as-you-go (PAYG) defined benefit (DB) systems. This is also true in East Asian countries such as Japan, Korea, PRC and Viet Nam. In South and Southeast Asia (Singapore, Malaysia, India and Sri Lanka) and Africa, on the other hand, provident funds are common. Additionally, many countries have special plans for civil servants. All pension systems have problems.

**10.** Central or employer-run provident funds are systems in which a worker pays a defined contribution (DC) and gets back his contributions plus interest at the end. The benefits are that it maximizes individual responsibility, promotes capital accumulation, and helps avoid the problems associated with PAYG systems. But they can result in government control of investments, concentration on short-term treasury notes, low diversification, and low or even negative returns.

**11.** More fundamentally, provident funds often fail to provide adequate pensions for old age, especially for low-income groups. Furthermore, they do not lead to an optimal allocation of capital, do not contribute to financial market development, and may encourage excessive government budget deficits, as is evident in, for example, India and Sri Lanka.

**12.** In the pay-as-you-go defined benefit (PAYG DB) pension systems, current workers' contributions are used to pay today's pensioners, so they are not an investment fund. The primary benefit of PAYG DB is that benefit is paid according to a formula that depends on wage and years of contribution. Other advantages include the fact that they provide a lifelong pension, guarantee wage replacement and thus protect pensioners from uncertain longevity and financial risks. They can also redistribute income.

**13.** Some common problems with PAYG DB systems are that they promise benefits that are too high and set the retirement age too low. They often lead to an accumulation of a large implicit pension debt, require large taxes on future generations as the population gets older, and induce workers and employers to evade tax, which forces a reduction of benefits. Therefore, these systems are often unsustainable and guaranteed benefits are not, in fact, guaranteed.

**14.** PAYG DB systems also adversely affect the economy as a whole. They lead to high payroll taxes, discourage formal sector employment, encourage early retirement, reduce savings and hamper the development of financial markets. The implicit pension debt, or the present value of liabilities over assets of the PAYG DB pension system, is large and growing in many Asian countries, including Japan (150 percent of GDP) and PRC (50 percent of GDP).

**15.** Some countries have adopted parametric or marginal reforms to tackle their pension problems. These reforms include decreasing the replacement rate, increasing the contribution rate, or raising the retirement age. These reforms are politically difficult and, more fundamentally, do not produce benefits such as an increase in long-term savings nor financial market development that would occur with full funding.

## *Introducing Multi-Pillar Systems*

**16.** Many countries have thus reformed more structurally by adopting a multi-pillar system. These are mixed funded and PAYG (i.e. a combination of PAYG DB and provident fund). The PAYG DB is smaller and redistributive, whereas the funded part is controlled by the private sector and has diversified investments. These multi-pillar systems allow for individual responsibility but at the same time provide a social safety net. Examples in Asia include Australia, Hong Kong, China and Kazakhstan.

**17. The Multi-Pillars of Old-Age Security**

| | I | II | III |
|---|---|---|---|
| | **Mandatory publicly-managed pillar** | **Mandatory privately-managed pillar** | **Voluntary pillar** |
| **Objectives** | Redistribution plus co-insurance | Savings plus co-insurance | Savings plus co-insurance |
| **Form** | Flat of means-tested or minimum pension guarantee | Personal savings plan or occupational plan | Personal savings plan or occupational plan |
| **Financing** | Tax financed | Regulated, fully funded | Fully funded |

**18.** In such a multi-pillar system, as shown in the table above, Pillar I provides a social safety net, is publicly managed and tax financed, and has a strong redistributive element. Pillar II, which involves defined contributions, is funded with funds that are privately managed. Its primary purpose is to provide for retirement. Pillar III is voluntary and for those who want additional consumption in old age. All three pillars co-insure, diversify risks, and combine individual and social responsibility.

**19.** Forms for Pillar I include minimum pension guarantees, flat benefits (universal, contributory, or means- and asset tested), and are earnings-related (compressed, notional DC with floor, and downsized DB). Pillar II involves mandatory savings for old age, and DC instead of DB. Funds are privately managed and regulated but not over-regulated. One possible form for Pillar II is individual accounts, which maximize individual responsibility but entail the problems of misinformation, volatility and, often, high administrative costs. To remedy these problems, countries such as Bolivia and Sweden have introduced limited choice, but this creates potential problems of its own, most notably corruption. A smaller Pillar I entails fewer PAYG problems and a larger second pillar, but also higher transition costs.

**20.** Pension systems should move in the direction of DC, funded, and competitively-managed systems. A DC system is desirable because it links benefits closely to contributions, discourages evasion and early retirement, avoids hidden redistribution, and promotes labor mobility due to portability. A funded system is desirable because it avoids unrealistic benefit promises, provides higher taxes as the population ages and intergenerational transfers, while at the same time promotes saving. A competitively-managed system is desirable because it bases investment decisions on economic rather than political criteria, allows for the highest return on savings and the highest productivity of capital, reduces risk through diversification, and promotes the development of financial markets. Chile is an example of extremely successful multi-pillar pension reform.

**21.** So how can Asian economies move toward successful pension reforms? Economies with PAYG systems can downsize their DB pillar and add a funded DC pillar. Economies with significant severance payments can turn those payments into a DC retirement pillar. In addition, allowing employers to opt out of earnings-related state DB plans should be considered. Economies with provident funds can decentralize control and allow workers or employers to opt out of the central fund, as well as pursue international diversification.

**22.** Right now, Asia is at a crossroads in the context of pension reforms. Some important questions are: Will provident funds be decentralized and deregulated to provide better returns and promote financial market development? Will PAYG DB plans be restructured so as to become sustainable with the addition of a funded pillar? Can economies avoid creating new unsustainable PAYG DB systems? Finally, will coverage be expanded and what kind of income security will be provided for the majority of the population that remains uncovered?

**23.** Immediately after her presentation, Dr. James engaged in a thorough exchange of views with the participants. The discussions centered on the differential impact of DC and DB systems on incentives to retire early, the necessity to carry out pension reforms with due regard for minimum income support for lower income groups, managing funds, and reforming over-generous civil service pension systems.

## Policy Design and Implementation

**24. Professor Olivia S. Mitchell** of the Wharton Business School, University of Pennsylvania, spoke on ***Building an Environment for Pension Reform: Global Lessons for Design and Implementation***. Aging populations throughout the world are putting pension systems under severe stress and giving impetus to pension reforms. Such reforms take either the form of tinkering at the margin with parameters of existing systems or more fundamental restructuring. While the problems faced by the various pension systems, and hence by necessary reforms, are not identical, the ultimate goal is to make old-age benefits affordable and efficient. Professor Mitchell stated that the two main objectives of her presentation are to first show that pension systems are a long-term contract and, second, that they therefore require long-term institutional and regulatory stability.

**25.** Pensions are unique financial instruments that aim to deliver affordable, reliable benefits far into the future. Their key feature is that they are long-term contracts. An important issue associated with pensions is to gauge the appropriate time horizon. A pension manager's objective is to maximize the financial security of participants' retirement subject to various constraints, including individuals' ability and willingness to save and the availability of possible assets that will convert savings into retirement income.

**26.** Pension participants face four distinct types of risk: individual risk, retirement system risk, countrywide risk and global risk. There is no risk-free pension and reducing risk is necessarily costly. Designing a retirement system requires risk avoidance, or reducing the risk of an undesirable outcome, as well as insurance, or protecting participants financially in the event of an undesirable outcome. Such protection is never free.

**27.** Individual risk avoidance includes building earnings capacity, paying into pension plans and investing well. Individual risk insurance involves developing insurance markets and providing poverty support. Retirement risk avoidance involves accurate disclosure, clearly defining performance for pension managers, and promoting competition among pension managers. Retirement risk insurance involves things such as government guarantees on benefits for DB and for rate of return for DC. Countrywide risk avoidance requires strong banks, flexible exchange rates, and a strong legal system that properly enforces contracts. Countrywide risk insurance would strengthen annuity providers and provide inflation-indexed bonds. It is impossible to diversify against global shocks such as war or capital market shocks. Retirement systems should not pretend otherwise and promise more than they can deliver in those circumstances.

**28.** Professor Mitchell then discussed various steps to strengthen the institutions to support pension reforms. The first step is to make old-age income support system credible by clearly outlining the objectives of the retirement system and make only promises that can be reasonably kept. The second step is to reform the tax system. Most pension systems rely on taxes for revenue and many countries do a poor job of taxing pensions. The most effective taxation is the EET or to exempt contributions and investment while taxing withdrawals. The third step is to reform the financial infrastructure. The importance of this can be seen by, for example, the inability of weak banks to properly evaluate and monitor long-run projects. The fourth step is to reform the labor market, in particular high tax rates and unaffordable benefits that threaten the labor market. The fifth step is to adopt a flexible monetary policy. Monetary policy, in particular absence of currency controls, is the key to public confidence in a government's economic management.

**29.** As to the issue of sequencing – whether to implement pension reforms before or after other policy reforms – there is no simple answer. However, many agree on the following elements: downsize the PAYG DB pension system, invest in record-keeping information technology, structure funded accounts, restructure the labor market and tax system, strengthen financial markets and diversify assets, and reform the insurance market.

**30.** It is also worth noting that funding improves pension security only to the extent that assets are well managed. This refers to the important issue of 'pension governance'. Investment concerns include ignorance and fraud, unrealistic asset valuation (for example, Japanese pensions' interests in troubled banks), shareholder activism motivated by non-economic criteria, as well as the belief in some developing countries that the investment of pension assets must be guided by political and social criteria rather than profit. The overall results include lower returns and higher risk, potentially reduced benefits, and greater uncertainty for participants and taxpayers. A strong pension management policy is required to avoid such outcomes.

**31.** In conclusion, pensions are long-term contracts for old-age consumption. Recent U.S. legislation requiring a 75-year perspective when making pension policy confirms this fact. Furthermore, pensions do not exist by themselves in a vacuum but instead rely on stable economic, financial, fiscal and monetary conditions. A well-run pension system, in turn, helps to further strengthen such stability.

**32.** Professor Mitchell exchanged opinions with the participants after her presentation. The main discussion centered on risk diversification through international investment of the pension fund's assets, potential global reduction of asset values in the future associated with global aging, non-liquidity of retirement assets such as housing, the need to take a long-term perspective in pension fund management, and various taxation issues.

**33.** **Professor Mukul Asher**, Associate Professor, University of Singapore, started his discussion of ***Reforming Pension Systems in Asia: Key Policy Issues*** by conceptually noting that pension systems are intermediary institutions for the well-being of the old as well as other age groups. Due to limited resources, any society must weigh the well-being of both of these age groups. How a society is characterized depends largely on three parameters: consumption by the elderly versus the general population, the proportion of elderly in the population, and society's total consumption (as a percentage of GDP). These parameters will determine the total cost of supporting the retired.

**34.** The main objective of a social security system is to provide a substantial proportion of current and future retirees with an adequate rate of replacement and a high degree of sustainability. This should be achieved while minimizing possible adverse effects on economic growth, fiscal burden, equity and international competitiveness. Professor Asher emphasized that it mattered very much how pension funds were invested. For example, if 100 percent of the funds were invested in government securities, then an apparently funded system may, in fact, be a PAYG system to the extent that future taxpayers are liable for those securities.

**35.** Professor Asher then discussed the advantages and limitations of a **national provident fund (NPF)**. The advantages include establishing individual responsibility for old age provision, promoting a savings habit in the population, and changing the composition of savings toward longer-term savings and thus facilitating the development of capital markets. On the down side, to name just a few disadvantages, NPF fails to provide social security benefits immediately after implementation, relies on the government as a regulator and guarantor of integrity, and makes resources available for retirement consumption highly sensitive to the real rate of return.

**36.** Professor Asher next discussed the present state of social security systems in Southeast Asia. Some key assumptions underlying the East Asian approach to social safety nets include an expectation that rapid economic growth will continue into the foreseeable future and that social security is essentially a private concern for families, employers and communities. In addition, East Asian governments adhere to an organic view of the relationship between the individual and the state, and thus stress the needs of the state above those of the individual.

**37.** He emphasized the reasons why the sustainability of formal social security systems is important across Southeast Asia. In the first place, industrialization and urbanization are eroding informal family- and community-based support systems. Southeast Asian countries are experiencing both individual aging and aging of the population structure. At the same time, the region's morbidity and mortality profiles are converging with those of advanced countries. Continued economic growth and westernization are bringing about a shift of general attitudes toward more individualistic lifestyles and consumption patterns. Furthermore, the Asian financial crisis made equitable burden-sharing much more important for social cohesion.

**38.** In terms of the structural characteristics of Southeast Asian social security systems, informal systems continue to play a very important role. Among the formal systems, mandatory DC fully-funded systems dominate except for public sector workers, among whom PAYG arrangements dominate. Nevertheless, the social insurance principle is not completely absent, particularly in the Philippines and to a lesser extent Malaysia. For instance, the Philippines maintains a partially-funded PAYG social security system.

**39.** In terms of coverage, the overall figures are quite low for the proportion of contributors in the labor force. The proportion ranges from 10 to 15 percent in Indonesia and Thailand, 28 percent in the Philippines, 50 percent in Malaysia and 65 percent in Singapore. This means that a large majority of Southeast Asians remain outside the formal social security systems. A related concern is the relatively low replacement ratios throughout the region. Although there are no official figures for these ratios, they are as low as less than 10 percent of wages, as in the case of Indonesia. Furthermore, the average balances in pension funds are small relative to per capita income in all the countries of the region, including Singapore. Pre-retirement withdrawals tend to be extensive in Singapore, moderate in Malaysia and the Philippines, and low in Thailand and Indonesia. Tax treatment tends to be fairly generous throughout the region, especially in Singapore and Malaysia.

**40.** In the context of broad directions for pension reforms in East Asia, Professor Asher pointed out the need to expand coverage to include a larger segment of the population. Furthermore, there is an urgent need to change the mindset of the public and the policymakers so that they understand that pension management is an important and integral element of economic management and overall performance. The governments of the region would also do well to carefully reexamine specific design, institutional, regulatory and incentive issues in their pension systems with the aim of improving their respective country's systems. A major concern remains the low and variable replacement ratios. There is also a need to take a broader systemic view of social security as opposed to a narrow, purely technical and ad hoc view.

**41.** At present, the savings function is overemphasized and there is inadequate recognition that DC fully funded systems do not necessarily increase national savings. Indonesia and the Philippines should address the actuarial sustainability of their PAYG DB systems, while other countries should make the government's contingent pension liabilities more explicit. Steps should be taken to minimize such liability in the future. Asian pension funds should also reduce administrative and compliance costs, and improve their housekeeping. Asian pension funds should in addition improve their investment performance and regulation. There is much to learn from other countries, including those in Latin America, particularly with respect to adjusting systems for longevity and inflation. Otherwise, the entire region risks being left behind in this increasingly important area of pension reforms. Even with reforms, a substantial proportion of the population will continue to remain vulnerable. So strong government involvement, including tax-financed programs, will continue to be essential.

**42.** An active question and answer session followed Professor Asher's presentation. Some interesting issues that were discussed during this session include the analytical equivalence of funded systems that invested heavily in government securities with PAYG systems; government investments in productive infrastructure; the need for transparency when the government uses funds from pension systems; legal and political-economy obstacles to international investment in developing countries; and the importance of domestic financial market development as a precondition for productive investment and risk diversification.

**43.** Small group discussions were also organized for participants to prepare country reports on pension reforms in their respective countries. The groups provided a forum for exchanges in which the participants benefited from the resource speakers' expertise and the resource speakers learned about the specific pension systems of the participants' countries.

## Fund Management Fundamentals

**44.** **Mr. Greg Cooper**, Director, Asset Consulting, Towers Perrin Forster & Crosby (TPFC), Singapore, and **Mr. Philip Brooks**, Senior Asset Consultant, TPFC, Singapore, discussed ***Pension Fund Management Fundamentals***. In developing pension fund arrangements, there are usually three options available: fully funded, partially funded, and PAYG. Since PAYG pension systems do not generate a pool of funds available for investment, they do not require pension fund managers. A funded pension system generally has strong saving and capital market advantages over a PAYG pension system. Furthermore, a fully-funded system requires lower contribution rates than a PAYG system for providing the same level of pension benefits. However, both Mr. Cooper and Mr. Brooks strongly emphasized that there is a need for proper management to ensure that such potential benefits are, in fact, realized.

**45.** Alternative models for funding include wholly private sector (Hong Kong, China and Australia), wholly public sector (Singapore), or a combination of both. Although the general public tends to believe that wholly private systems produce better returns than wholly public ones, this is not necessarily the case. For example, Singapore's system compares favorably with the system in Hong Kong, China in terms of overall performance. That is, private sector performance does not guarantee efficiency. Many business and retirement funds in Asia adopt a "laissez-faire" approach with no clearly defined objectives or long-term strategies. They simply select fund managers and provide them with assets for the goal of beating inflation, or each other. Hong Kong, China best exemplifies this approach, which has clearly been ineffective.

**46.** Investment returns depend on a number of benefit and cost factors. In terms of benefits, there is a need to consider stock allocation, asset allocation (equity, bonds or cash), currency position and other revenue sources. In terms of costs, there is a need to take into account management expenses and investment expenses. Efficient management involves maximizing investment returns and other revenues, as well as minimizing costs, both management expenses and investment expenses. When minimizing management expenses, emphasis should be on examining the value of services rather than just the amount of fees. It is also important to examine all these factors in terms of their total impact on the plan rather than in isolation.

**47.** Asset allocation decisions have the greatest impact on long-term investment return but asset allocation returns can be extremely volatile. It is interesting to note that 90 percent of returns are due to strategic or long-term asset allocation and only 10 percent due to managerial skill. It is important to distinguish between strategic asset allocation (long-term asset allocation which is appropriate for a scheme given its liability structure and the risk profile of the members and sponsors) and tactical asset allocation (the short-term asset allocation of schemes to take advantage of short-term market movements).

**48.** The basics of pension fund management involve three key phases. The first – the determination of an investment strategy – requires developing investment objectives and strategy, and developing an implementation strategy. The second – the implementation of the strategy – involves defining management and administration needs and selection criteria, selecting managers and custodians, transferring assets and funding the plan. The third – monitoring the strategy and structure – involves comparing results with expectations and objectives. In many developing countries, the first phase is skipped altogether, resulting in sub-optimal outcomes.

**49.** A structured approach to pension fund management consists of setting objectives and the investment strategy, configuring management and custodianship, selecting the manager and the custodian, and monitoring performance. The establishment of objectives is critical because it determines the aims to be achieved through the investment of assets. Setting the investment strategy in turn involves developing an asset model, determining assumptions, generating the efficient frontier, and assessing and selecting portfolios. Management configuration centers on issues such as outsourcing versus in-house fund management and active management versus indexing. While the trustee or board retains control of long-term strategic asset allocation, which determines 90 percent of investment returns as noted earlier, fund managers may add value to portfolio performance through sector performance or market timing. To this extent, selecting the right manager is important. Finally, manager reports, which is necessary for monitoring performance, should include an attribution analysis of performance against overall and sectoral benchmarks to determine how and where value has been added.

**50.** The presentation was immediately followed by a Q & A session where the participants asked technical questions relating to the fundamentals of pension fund management. Such questions included the difference between an investment manager and a custodian, the division of responsibility between various parties in setting investment objectives, the need to limit the influence of the investment manager on investment objectives, how to best minimize country risk through international diversification of investment, and how to manage currency risk associated with international investments.

## Financial Market Development & Pensions

**51.** A country with a pay-as-you-go pension system needs to make the difficult transition to a funded system if it wishes to build capital markets with private pension funds as they have done in many developed countries, or in Chile.

**52.** **Dr. R. Thillaninathan**, Director of Finance, Genting Berhad, Kuala Lumpur, gave a presentation on ***Pension Funds and Financial Market Development***, with special reference to the Malaysian experience. Malaysia's Employee Provident Fund (EPF), which is a funded and mandatory scheme, is considered one of the most successful provident funds in the world considering the various constraints within which it has had to operate. EPF is a defined contribution (DC) plan and based on mandated contribution levels and mandated investment portfolios, which are dominated by Malaysian government securities. EPF is underinvested in domestic equities and not invested at all in foreign bonds and equities.

**53.** The underdevelopment of the fund management industry and hence financial markets in Malaysia is partly attributable to the centralized investment of the massive pool of forced savings in EPF. This problem of over-centralized savings mobilization and investment management can be best dealt with by reviewing the asset allocation mix, investment management approach and contribution rates. Given the large potential benefits of portfolio diversification, persuading the government and contributors to adopt the right asset allocation mix is a high priority task.

**54.** Due to underdeveloped domestic financial markets and restrictions on international diversification, EPF has been facing a serious problem with the extent to which it has been able to invest in marketable securities. Underdeveloped markets have also pushed EPF toward a more active style of investment management, and hence higher costs, higher risks and greater vulnerability to external influences in decision-making. This is particularly true for investments in non-marketable securities but also holds true for investments in marketable securities.

**55.** Underdeveloped financial markets have seriously constrained optimal management of the provident fund and inhibited pension reform in Malaysia. With underdeveloped financial markets, a pension fund cannot be managed and evaluated on a portfolio basis, which means a greater scope for outside intervention in decision-making. Thus it is not possible to rely on the exit route of selling to promote corporate-governance best practices thereby increasing the risk of expropriation. Furthermore, portfolios are not likely to be market-to-market which leads to overpayment and underpayment whenever withdrawals are made, making a policy of holding a portfolio to maturity commonplace. This encourages non-optimal investments and prospective retirees will be less well-placed to smooth consumption over their retirement period given that a market in annuities has not developed.

**56.** Pension reforms, therefore, also require financial market reforms. The underdevelopment of financial markets, in particular the fund management industry and debt markets, will severely constrain the agenda for pension reforms. A prime example is the short supply of fixed-income products, which has contributed to EPF's underinvestment in marketable securities and hampered the development of a market in annuity products. The absence of an active and liquid market in fixed income products is something that the government must rectify in order to facilitate pension reforms. By contrast, the equities market is fairly well developed in Malaysia and EPF's underinvestment in equities is largely a result of legislative restrictions.

**57.** Reforms are particularly urgent in four main areas of the financial market: the fund management industry, the bond market, securitization of debt, and the cross currency swap (CCS) market. To develop an active secondary bond market, it is necessary to free yields, reduce or do away with reserve and liquidity costs, and to reduce the risk premium. An active and liberalized CCS market is especially important in the absence of a well-developed and liquid domestic bond market because the yield curve it generates can be used as the benchmark yield curve for issuing and trading corporate debt securities and increasing their supply.

**58.** Dr. Thillaninathan concluded his presentation by noting that pension reforms can only promote capital market development to a limit. Pension reforms require capital market development. Therefore, there is a symbiotic relationship between pension reforms, on the one hand, and financial development on the other. They are mutually interdependent and help to reinforce each other.

**59.** During the discussion session, Dr. Thillaninathan and the participants debated on the underdevelopment of annuity markets in most Asian countries, the low average balances in Asian pension funds, a pronounced preference of the general public for equities over bonds in some Asian countries, and the need to liberalize and deregulate the banking sector as well as the insurance industry.

## Governance and Regulation

**60.** **Mr. Raymond Tam**, Executive Director, Mandatory Provident Fund Schemes Authority, Hong Kong, China gave a presentation on ***Pension Fund Management: Governance and Regulatory Issues***. Mr. Tam distinguished between employer-based pension systems and employee-based pension systems. In the former, employers select the pension schemes and in the latter, employees do so. Each has its own advantages and disadvantages. There are also hybrid systems in which the employer selects the scheme for current contributions, whereas the employee selects the scheme for past contributions.

**61.** It is worthwhile to distinguish between trust arrangements and insurance arrangements. Under a trust arrangement, the fiduciary duties of the trustee include prudence, diversification of investments, and compliance with governing rules. Beneficial ownership is vested in scheme members and scheme assets are protected against the bankruptcy of the trustee or employer. Under an insurance arrangement, pension contributions become part of the assets of an insurance company, and there is no protective "ring-fencing" of assets. An insurance arrangement entails complicated product designs and combines an investment element with an insurance element.

**62.** Regulation of pension scheme operators centers on licensing criteria. These include capital adequacy, financial backing from parent firms, performance guarantees, professional indemnity insurance, experience and resources, and sufficient local presence. Further licensing criteria include competent directors and controllers, an independent director, proper internal controls, external auditors, and whistle-blowing by service providers. Supervision and monitoring of scheme operators involves a review of regular reports and accounts, regular field inspections, special audits and investigations, and report of irregularities. In connection with the results of supervision and monitoring, the regulator can demand remedial actions, suspend scheme administration, revoke licenses and transfer scheme assets.

**63.** While some scheme operators provide one-stop service in the sense of providing all services, others out-source some services to other firms. The former facilitates regulation but results in high entry-costs and thus reduces product choice and competition. It is also possible to distinguish between central administration service providers (CASP) and decentralized administration. CASP is a common, single government-owned scheme administrator that provides centralized computer systems, and performs back office functions as well as most front line functions. The advantages of CASP includes the elimination of the need for scheme operators to develop their own administrative systems while the disadvantages include reduced flexibility for scheme operators in designing their schemes. The overall implication of CASP is that it turns a privately-managed system to a centrally-managed system, and concentrates the risk of system failure.

**64.** Investment regulation falls into two different types of approach – a “relax approach” and a “detailed approach;” each with its own advantages. For example, a ‘relax’ approach allows more flexibility for fund managers whereas a ‘detailed’ approach instills public confidence in the system, especially during early years. There are several essential factors for formulating investment standards: guarding against inappropriate investments, diversification of risks, liquidity of investments, good investment practices and conduct, asset allocation rules, and rules concerning foreign currency investments.

**65.** Marketing intermediaries are regulated to minimize the risk that the intermediaries will mis-sell the schemes. Factors relevant to the regulatory framework include minimum qualification and experience, creating a level playing field, and establishing a code of conduct.

**66.** Finally, the system can be governed by either a single coordinator or coordinated regulation. The main advantage of having a single coordinator is that it is a centralized approach that can tailor-make regulatory requirements and address the inadequacies of existing regulatory regimes. On the other hand, the advantages of coordinated regulation is that the retirement scheme regulator only licenses the scheme operator, allows for coordination with existing regulators in banking, securities and insurance, and eliminates the need for a bulky structure for the regulator.

**67.** **Professor Olivia Mitchell** spoke on ***Strengthening Pension Governance and Management***. The basic problem is that many pension programs lack credibility due to the fact they pay out high benefits, but are dependent on taxes that cannot be fully raised or guaranteed. Thus, DB plans tend to be underfunded, investment results are often unsatisfactory, and pension boards sometimes suffer from conflicts of interest.

**68.** So the key question is: How can pensions do better? This is intricately connected with pension management and governance, which consists of four main areas: legal structure, reporting and disclosure, performance benchmarks and evaluation, and asset management. In terms of the legal structure, there is a need to minimize conflicts of interest, clearly delineate participant rights, and follow the *prudent person rule* in the context of trust law and contract law. The *prudent person rule* basically states that managers must invest in the best interest of the participants.

**69.** In terms of reporting and disclosure, transparency is urgently needed with respect to expenses, assets and rate of return. Fortunately, the tendency is now converging toward widely followed international standards in this area. Asset/liability valuation, common underlying assumptions, expenses, net returns and risk all have to be reported and disclosed transparently.

**70.** In terms of performance standards, there must be credible performance reviews and penalties for non-compliance. Due diligence is required for expenses, risk/return performance, revenue collection and benefit payment, as well as liability. Asset management must be shielded from politics. Institutional structure relates to board size, composition, membership, and authority. There must be competitive bids for outsourced investments and tight controls on in-house investments, as well as full disclosure and transparency.

**71.** A public pension board’s duties include day-to-day administration, hiring directors and staff, choosing actuarial assumptions, setting investment and benefit policies, and hiring and firing outsourced money managers. Moving on to public pension board reporting, liability insurance is required in 40 percent of plans. Most plans also require boards to submit separate annual reports to participants and the government, and most have annual actuarial valuations.

**72.** Evidence indicates that plan governance influences investment outcomes. Retirement representation on the board cuts returns slightly due to a more conservative investment strategy, in-house and external money managers have similar investment patterns due to competition, and the requirement to invest in own-state projects lower returns in some years.

**73.** 401K pensions, an alternative DC pension that allows for multiple investment options in which the employer pays matching contributions, are rapidly gaining popularity in the United States. Their total assets have recently surpassed those of DB schemes. This brings up the issue of disintermediation, since the individual can make investment choices on his own without the help of an intermediary. Disintermediation has both pluses, such as a strong feeling of ownership, and minuses, such as possibly low participation knowledge.

**74.** Professor Mitchell concluded by pointing out that pension governance and management are not simple, governing pension boards require clear rules and penalties, disintermediation is growing and, finally, participants need to be better educated about the potential risks associated with individual choice.

**75.** The ensuing discussion among Mr. Tam, Professor Mitchell and the participants revolved around the adverse impact of financial unsustainability on the credibility of the regulatory and institutional framework, the necessity of improving compliance and economizing administration costs, adoption of systematic rather than *ad hoc* investment policies, country experiences of using privatization proceeds to finance the transition costs of moving to a funded system, the *prudent man’s rule* to be followed by trustees, the complex case law evolving around this rule, the key role of an efficient legal system in enforcing this rule, criteria for judging the performance of fund managers, and competition among fund managers.

## Capsule Reports:
## Latest Experiences of Reform

### *A. Japan*

**76.** **Professor Naohiro Yashiro**, Sophia University, Japan, spoke on ***Pension Funds Reform: The Case of Japan***. Japan's pension system is currently undergoing significant changes to address the issues of a rapidly aging population and the slowdown of economic growth. Major political debates are currently underway on reducing public pension benefits in order to restore intergenerational equality by preventing further increases in contributions in the future. Private sector pensions also suffer from low returns and financial unsustainability, and reforms in this area center on doing away with the over-regulation of pension fund management. While Japan's pension problems are hardly unique and are shared by many other countries, they are particularly serious in light of Japan's large "demographic risk" – a rapidly aging population structure combined with increasing female participation in the labor force and declining fertility.

**77.** In 1973, the public pension system changed from a funded system to a *de facto* PAYG system. The shift reflected a greater social desire to spread the fruits of economic growth to social security. Unfortunately, the two key assumptions underlying the change of system, namely stabilization of fertility rates and continued rapid growth, fell apart a few years after the new system was adopted. Falling fertility and economic slowdown have continued well through the 1990s, making public pension reform all the more urgent. Fiscal sustainability can be restored by either (i) raising contribution rates or (ii) reducing pension benefits. The government is favoring the reduction of benefits since this reduces intergenerational inequality. Specific proposals include raising the retirement age and eliminating wage indexation. While this is a step in the right direction, the magnitude of reduction in benefits falls far short of what is required to restore the pension fund's viability and bolder plans are obviously required.

**78.** Japan's private pension system, which supplements the quasi-universal public pension system, is fully funded and is intended to provide extra old age consumption for its members. It also encourages workers to stay in one company for their entire working life. Private pension funds consist of two main types: the tax-qualified pension scheme (TQP) that are prevalent in smaller companies, and "contract-out" pension scheme (Employees' Pension Funds or EPF) that prevail in larger firms. Japanese pension funds and financial markets have traditionally been heavily regulated to protect the interests of the employees. The cost of such over-protection and over-regulation, however, has been low rates of return relative to countries with more competitive financial markets. Therefore, deregulation and liberalization of the pension-fund management industry is needed. Such deregulation and liberalization must be accompanied by clear, fair and transparent rules for the market. For example, there must be rules of responsibility that force companies to disclose the financial transactions of their pension funds.

### *B. People's Republic of China*

**79.** **Dr. Estelle James** began her discussion of ***Pension Reform: The Case of PRC*** by noting that by 2030 the elderly will account for 22 percent of PRC's population. Public pension spending in PRC will rise to 10 percent of GDP if it follows current policies, seriously interfering with the country's ability to invest in health, education and other public goods.

**80.** PRC's current system is PAYG DB and suffers from problems such as high replacement rates, early retirement, and wage indexation, all of which necessitate high contribution rates. Furthermore, the population is rapidly aging, driving contribution rates even higher. A peculiar feature of PRC's pension system is that it is fragmented into the levels of state-owned enterprises (SOEs) and municipalities rather than a national system. Dependency rates and contribution rates differ greatly across localities and this creates significant problems, such as hindering labor mobility. Furthermore, the current PRC system does not cover workers in the dynamic and growing private sector.

**81.** Although the implicit pension debt is currently rather small at 50 percent of GDP, it will continue to grow unless the system is seriously reformed. The current system is simply not sustainable in the absence of reforms. Just as important, the system is adversely affecting the economy as a whole. For example, high contribution rates raise labor costs in depressed regions of the country, rendering them unattractive to capital and thus furthering the decline of those regions.

**82.** Fortunately, PRC authorities seem to be aware of the existence of serious pension problems in their country. They want to adopt a multi-pillar system, expand coverage to the private sector, and gradually unify the system, but are finding it difficult to finance the transition (i.e. pay off existing pension liabilities). In addition, expanding coverage and unifying the system are hard to achieve because of political difficulties since any such change inevitably produces winners as well as losers.

**83.** PRC's intended direction of pension reforms is most evident in State Council Document 26, which outlines a multi-pillar pension system. Pillar I would pay 20 percent of average wages and the contribution rate would be 13-17 percent. Pillar II is essentially an individual account with an 11 percent contribution. All funds in this pillar would be invested in government securities. The total contribution rate would be 20 percent for employers and 4 percent (rising later to 8 percent) for workers. This kind of a multi-pillar system with a centralized fund is a common approach in Asia but it often leads to poor allocation of capital and low investment returns. In PRC's case, the low rate of return requires high contribution rates, which makes it all the more difficult to finance the transition – a task PRC has avoided so far. This means that most individual accounts in PRC are notional or purely for record-keeping purposes. The money in those accounts is used to pay current pensioners.

**84.** Unless a country can somehow finance the transition to a partially-funded system, it will remain *de facto* PAYG with long-term debts, even if it has individual accounts. A transition financing problem arises because part of the contribution is diverted to fund individual accounts so other resources must be found to pay existing pension debt.

**85.** PRC will keep part of the new system PAYG but will probably find it politically difficult to raise the retirement age. One possible way out of this dilemma is to use sales of SOE assets to finance the transition but it is uncertain as to how much money these sales will raise. Contribution rates are already quite high so raising them further is not an attractive option. The PRC government dislikes explicit debt so exchanging the implicit pension debt for explicit debt is politically difficult. Finally, the fragmented nature of the system will also hinder financing.

**86.** Expanding coverage to the private sector could help the transition by raising funds and providing protection for more workers, but this implies imposing high taxes on the private sector, the most dynamic component of the PRC economy. This may have serious consequences for economic growth and thus, not surprisingly, the private sector is already resisting.

**87.** A strong funded pillar requires lower contribution rates and would thus free up resources for transition finance. A funded pillar might grow stronger under a more liberalized investment policy that allowed for diversification into private securities, raising investment returns and capital productivity. Marginal productivity of capital remains high in PRC despite a high savings rate. Investment liberalization is likely to be preferred by the high-growth coastal areas. This will reduce resistance to the national unification of the pension system.

**88.** The challenges for PRC in the area of pension reforms are threefold. First, how should it finance the transition to a partially funded system? Second, how should it invest the funds more productively? Third, how should it expand and unify the system? The three issues are inter-related and resolving them in a satisfactory manner may be crucial to PRC's economic growth in the future.

## C. Singapore

**89.** **Mr. Ronald Chong**, Manager (Public Affairs), Central Provident Fund (CPF) Board, provided a description of ***Singapore's national provident fund***. He addressed issues such as coverage, contribution rates, withdrawal rules, interest earned by members, different types of participants' accounts, adequacy for old age support, and CPF benefits on retirement, healthcare, housing, family protection and asset enhancement. Quite aside from its primary function of providing for retirement consumption, CPF has played an important role in Singapore's nation building by promoting savings and home ownership as well as providing funds for infrastructure development.

**90.** An extended exchange of views ensued after the presentations. Discussion focused on the design of an optimal multi-pillar pension system, the relative importance of each pillar, the importance of providing a social safety net for the elderly poor, country-specific factors determining the precise structure of a multi-pillar system, the importance of building a system that is difficult to reform later (e.g. a large PAYG system), and the issue of whether the minimum pension amount for a retiree should be based on the family-level poverty line, intergenerational equity issues or a number of country-specific issues.

## D. Southeast Asia

**91.** **Professor Mukhul Asher** spoke on the ***Southeast Asian Provident and Pension Funds: Investment Policies and Performance*** by emphasizing that the primary goal of pension funds must be to provide pension payments for retirees. This is the benchmark against which pension funds must ultimately measure their performance. Although sound investment policies that generate satisfactory returns are certainly an important determinant of the rate of return, Professor Asher suggested that transactions or administration costs can add up to amounts that can significantly lower the rate of return for beneficiaries. Be that as it may, high administration costs *per se* are not necessarily undesirable if a wide range of services are provided in return. That is, one must look at value-for-money. All non-retirement objectives of a pension, such as contributing to financial and capital market development, are secondary and must be treated as such.

**92.** He then focussed his discussion on investment policies and returns of five Southeast Asian countries. In Indonesia, the pension funds' asset allocation as of 1994 was as follows: stocks 8 percent, bonds 11 percent, bank deposits 41 percent, short-term government paper 30 percent, properties and others 10 percent. During 1988 to 1995, the real rate of return for employer-sponsored plans was between 6 and 8 percent, a fairly good performance, although the mandatory scheme for most workers, Jamsostek, was considerably lower. In Malaysia, there has been a dramatic shift in the composition of assets in the 1990s. In particular, the share of Malaysian government bonds plunged from 73.6 percent in 1991 to 31.6 percent in 1998. For the 1987 to 1998 period, the annual real rate of return averaged 4.47 percent, a fairly satisfactory performance. In the Philippines, between 1994 and 1996, government bonds accounted for 44.3 percent of investments by the Social Security System in 1996, followed by loans to members, which accounted for nearly 40 percent. During the 1985 to 1995 period, the average annual real rate of return was 5.58 percent. In Singapore, the law requires that the national provident fund (CPF) be invested in government bonds. The government then uses these funds to make investments abroad, but their performance is not made public. The interests earned by the members are simply an average of the 12-month deposit rate and month-end savings rate of the four major local banks. In Thailand, as of 1996, provident fund investments were distributed as follows: cash and deposits – 49.2 percent; corporate debentures – 27.7 percent; debt instruments issued by banks – 10 percent; stocks – 8 percent; and others – 1.9 percent. Data on rates of return are not available.

**93.** Southeast Asia as a whole faces the following problems. National provident and pension funds do not enjoy functional autonomy. There is also a serious structural defect of the substantial mismatch between assets and liabilities. In the absence of financial market development, provision of adequate replacement rates to members is unlikely. Furthermore, retirement withdrawal is primarily in the form of lump sum and there is scope for cost improvements in housekeeping functions. Governments throughout the region will have to seriously tackle those problems if they are to make substantial progress in improving the performance of their pension systems. In conclusion, those governments will probably have to undertake institutional, regulatory and policy reforms, as well as educate the general public if their countries are to fully realize the benefits of funded pension systems.

**94.** Professor Asher engaged in an exchange of perspectives with the participants immediately after his presentation. They talked about, among other things, the definition of fiduciary responsibility and trusteeship, the primacy of members' retirement consumption as the pension's overall objective, the definition of short-term and long-term investments, the need to match a pension fund's assets and liabilities, the importance of government bonds as benchmark securities, the positive impact of funded systems on long-term contractual savings, and the indirect effect of pension reforms on the national savings rate.

## *E. Hong Kong, China*

**95.** **Mr. Raymond Tam** presented ***Hong Kong, China's country experience***. In particular, he provided a description of the country's new national provident fund, the Mandatory Provident Fund (MPF). The establishment of the MPF was largely motivated by demographic pressures arising from improving longevity and declining fertility, in addition to the weakening of traditional family support. MPF is a privately-managed DC employment-based retirement system. It is a trust arrangement that seeks to achieve cost effectiveness by maximizing free market competition. Contributions to MPF will commence in December 2000. The Mandatory Provident Fund Schemes Authority (MPFA) is the public body that supervises and regulates the MPF.

**96.** The MPF covers members of the workforce who are between the ages of 18 and 65. The coverage is almost universal with a few exceptions, most notably civil servants. Contributions are jointly made by employers (5 percent) and employees (5 percent), the accrued benefits are fully vested in scheme members, portable and preserved until death. Types of MPF schemes include master-trust, employer-sponsored and industry schemes. The choice of systems is based on a two-tier arrangement in which the employers choose MPF trustees and schemes, and the employees choose from the various investment options available under the MPF scheme chosen by the employer. Each scheme must have a clear statement of investment policy.

**97.** Investment standards and restrictions include following the prudent man's rule, diversifying investments, and choosing the appropriate investment grade and quality. The range of permissible investments is fairly wide. Every MPF scheme has to provide a capital preservation fund that invests in conservative assets. Regulation of investment management centers on licensing by the Securities and Futures Commission. Insurance policies and intermediaries are also regulated. MPF is expected to have a big impact on the broadening and deepening of Hong Kong, China's capital markets in the coming years.

## *F. Korea*

**98.** **Dr. Robert Holzman**, Director, Social Protection Group, World Bank, spoke on the ***Experiences of Korea***. Dr. Holzman noted that Korea is a latecomer in the pension business, having started a Bismarck-type system with reserve funds – the National Pension Scheme (NPS) – only in 1988. NPS is a publicly managed, defined benefit (DB) system available to all citizens. Participation is mandatory for employees of firms with 5 or more workers, farmers, fishermen, and those rural self-employed who are aged 18-59. Also, employees of firms with less than 5 workers and the urban self-employed have been required to join the system since April 1999. Since NPS is a young system, timely corrections are easy and feasible. Reform requires integration with existing retirement allowances and public sector schemes. Moreover, early up-front actions are needed. In addition to the NPS, there are more mature "occupational" schemes for civil servants, military personnel and private school teachers. A third main formal source of old age support is the retirement allowance which began in the 1950s and typically involves a lump-sum severance payment from employers to employees upon retirement.

**99.** NPS is financed by contributions from the employees (4.5 percent) and employers (4.5 percent). Current benefit pay-outs are small relative to contributions, so NPS has built up a large reserve fund amounting to some 10 percent of GDP. Unreduced benefits are available to the insured at age 60 with 20 or more years of service. Benefits are price-indexed and equal to 1.5 times the sum of average monthly earnings of all insured persons in the preceding year and the average monthly earnings of the retiree over the entire contribution period. The target replacement rate of 60 percent, after 40 years, is generous by international standards.

**100.** There are five main challenges for Korea's social security system. First, income support for the elderly poor must be provided. Second, the scope of the NPS and the retirement allowance scheme must be aligned (for example, by making the earnings-related condition of NPS voluntary). Third, retirement allowances, which are currently largely unfunded, need to be funded. Fourth, the financial sustainability of the "occupational" schemes has to be improved. Fifth, NPS's large reserve fund has to be better managed, primarily by limiting government access and improving the governance structure and asset management.

**101.** Dr. Holzman suggested that if Korea moved toward a decentralized multi-pillar system, this would create a win-win situation socially, financially and economically. Such a move would increase the probability of ensuring adequate old-age support. It would also strengthen contractual savings with shifts toward longer-term assets, equity financing and more liquid financial markets and in so doing, improve the capital structure of the corporate sector and hence the economy's productivity. At this stage, however, Korea is in the process of nurturing a consensus on the need for reform as well as a consensus on the broader direction of reform.

## G. Kazakhstan

**102.** **Mr. David Edwards**, Assistant Chief Economist, Asian Development Bank, spoke about the ***Experiences of Kazakhstan***. This ex-Soviet Central Asian country achieved its independence in December 1991. During the Soviet period, as is typical for socialist countries, there was a comprehensive social welfare system, which eliminated the need for independent old age provision. In June 1991, the government introduced a PAYG pension fund financed by a payroll tax on firms. With the severe recession in the wake of independence, the pension fund has had difficulties in meeting its obligations. Arrears of both pensions and wages are large and rapidly growing. The primary culprits were widespread evasion by firms reeling from the recession, hard budget constraints under a more market-oriented economy, and over-generous benefits. By 1996, it had become clear to the government that the pension system was in a deep crisis and unsustainable. Furthermore, demographic trends had become unfavorable so that holding off reforms was no longer a realistic option since they would become much more costly and difficult if adopted later on.

**103.** The government therefore decided to embark upon a bold course of pension reforms, with much external assistance. Around the end of 1996, the government opted for a defined contribution (DC) pension system as a new component in the social security system. The system would be financed by 10 percent mandatory payroll contributions by employees. The old PAYG system would be phased out over time with natural attrition of eligible beneficiaries. The necessary enabling legislation on the new pension system was enacted in June 1997 and the system commenced operation in January 1998. Three main issues were especially relevant to the new system's success. First, the new system had to gain widespread acceptance and credibility among the general public. Second, long-term sustainability required key investment instruments and market institutions. Third, the establishment and sustainability of the new pension system would require large fiscal adjustments.

**104.** The move to the new system will support Kazakhstan's transition to a market economy in several ways. Systemic transition and economic growth will be promoted by reducing labor market distortions, developing capital and financial markets, and promoting private savings. The primary risk remains a lack of public confidence in the prior pension system and financial institutions. Some resistance is already evident, particularly with respect to entitlement restrictions.

**105.** Nevertheless, the new system, which represents a radical reform, has had some initial success in terms of compliance. Out of an estimated formal workforce of 3.6 million, up to 3.4 million have begun to make the mandatory 10 percent contributions to the DC pension fund. Total assets reached around US$300 million toward the end of 1998, and are projected to rise to US$670 million at the end of 1999. The government has also managed to establish a strong institutional and regulatory framework to support the new pension system. Recently, however, compliance has been falling substantially, primarily due to credibility problems stemming from the failure of the previous system and lack of public confidence in the financial system. More than anything else, the Kazakh experience highlights the crucial role of credibility in designing and reforming pension funds since pensions are, in the final analysis, a promise of future payment to the individual by the government.

**106.** An interactive discussion of various issues took place between the resource speakers and the participants. These issues include the high transition costs of radical 'cold-turkey' pension reforms, the integration of income support for the elderly poor within the basic pension system, the range of permissible investment instruments in different Asian countries, the relative advantages of annuities versus lump sum payments, informal intra-family annuities in Asia, the appropriate structuring and size of annuities, and coverage of workers imported from other countries.

# Social Impact and Poverty Alleviation

**107.** **Dr. Ernest Pernia**, Lead Economist, ADB, discussed ***The Social Impact of the Financial Crisis in Asia***. This is relevant to the topic of Asian pension reforms insofar as old-age support is a social problem that tends to deteriorate during times of economic and social stress. ADB has performed an in-depth study of the social consequences of the crisis in 6 countries – Indonesia, Korea, Laos, Malaysia, Philippines and Thailand. The study had the objective of (i) examining the transmission, nature, and extent of social impacts; (ii) identify the groups most affected by the crisis; (iii) review the responses of households; (iv) review the responses of households, governments, the private sector, NGOs and communities to the crisis; and (v) suggest an improved system for monitoring and coping with social impacts in the future.

**108.** The social impact of the Asian financial crisis is reflected in a whole host of socio-economic developments. These include (i) rising prices and inflation; (ii) increasing unemployment, especially in construction and manufacturing; (iii) worsening income inequality and rising incidence of poverty; (iv) a negative impact on education, particularly at the secondary level; (v) reduction in health care consumption; (vi) erosion of community cooperation and participation, or social capital; and (vii) negative environmental effects.

**109.** The most vulnerable groups are families of workers who lost their jobs, and members of poor families whose limited coping responses have had serious consequences for children, women, elderly and disabled persons. The impact on the elderly, whose sources of income and health problems were especially vulnerable to the effects of inflation and family care capacities, was significant. Household coping-responses included cutting back consumption, seeking additional income sources and selling assets.

**110.** Dr. Pernia concluded his presentation by noting that it is too early to draw conclusions about the eventual social impact of the crisis due to the early and incomplete nature of the data. However, the crisis has provided many useful lessons by teaching us about how systems perform under stress. Furthermore, governments throughout the region have become more aware of their responsibilities, as well as their limitations and constraints.

**111.** The post-presentation discussion between Dr. Pernia and the participants touched upon the impact of the economic crisis on primary education and tertiary education, the definition of the poverty line, and government assistance to the elderly poor during the crisis.

**112.** **Dr. Robert Holzman, Dr. Estelle James** and **Professor Mukul Asher** gave interrelated talks on the subject of ***Pension Reforms and Poverty Alleviation***. Dr. Holzman's presentation focused on the issue of coverage, or lack thereof. In many Asian countries, a large part of the population does not have any pension coverage at all. Taking care of these people is just as important, if not more so, than reforming pensions themselves. Coverage is linked to a country's per capita income but countries with similar incomes sometimes vary widely in terms of coverage, implying a significant scope for improvement. Linking the benefits more closely with contributions certainly improves the incentives to participate but does not come close to completely solving the problem. There are five main obstacles to extending coverage, as discussed below. At the same time, there are several potential government actions to increase coverage.

**113.** The first obstacle to expanding coverage is that the poor usually do not find paying mandatory contributions to be in their self-interest. The reason is that the poor often do not have access to liquidity and credit, and suffer greater income volatility and higher mortality than the population-at-large. As such, traditional support systems such as intra-family assistance may still provide better risk management for poorer families in developing countries.

**114.** Second, the self-employed are also unlikely to participate in contribution-based pension systems because these constrain their ability to make productive investments. Furthermore, participating in such systems usually brings them under additional regulations and taxes (i.e. in a move from the informal sector to the formal sector of the economy).

**115.** Third, if transactions costs such as pension fund administration expenses are substantial. These further cut into the real rate of return of participation and hence incentives to participate, particularly among the poor and the self-employed. Furthermore, on the supply side, the transaction costs of providing financial services to the working poor may be too high to attract fund managers.

**116.** Fourth, specific features of system design may also hinder participation. For example, if a participant becomes eligible for benefits only after, say, twenty years of participation, the poor and others with shorter expected life spans may not participate. The current regulation of pension-fund investment causes distortions, limits returns, and restricts workers' choices.

**117.** Fifth, an important point is that households may have little confidence in the promises of the government. If the previous pension system did not perform well in terms of delivering the promised benefits, even a reformed system may have serious difficulties in winning widespread trust and acceptance among the public. Thus households will consider the financial risk of the reformed systems too high for them to participate.

**118.** In terms of voluntary and market-based provisions for old age, a highly significant coverage issue concerns those who are not currently poor but may become poor in the future, particularly informal-sector workers and the self-employed. A big problem for these groups is that they often do not have appropriate financial assets that help them smooth their inter-temporal consumption path. Specific issues that arise in this area include (i) whether to adopt formal or informal institutions; (ii) what instruments (e.g. deposits, securities, insurance contracts) to choose; (iii) what the transaction costs are (e.g. urban versus rural population); and (iv) what is the role of the government.

**119.** Universal categorical flat-rate or means-tested programs are possible solutions to help those without pension coverage. Universal schemes are not restricted to rich countries but also exist in some developing countries as diverse as Bolivia and Namibia, and the fiscal burden relative to GDP can be quite moderate. Means-tested schemes provide either general or categoric (e.g. widows, etc.) benefits. Implementing such schemes requires an administrative capacity for income and asset testing, but the transaction costs for such testing are often high. Means-testing can also create a moral hazard problem, particularly for those near the cut-off income level.

**120.** Finally, family-based support systems and NGO-based systems should not be ignored in debates about coverage since such systems can potentially be a vital source of assistance for the uncovered. However, it is unclear how effective government measures, such as tax benefits and subsidies, are in promoting family support. Also, a big concern with NGOs is the issue of how sustainable they are.

**121.** Professor Asher noted that Dr. Holzman's presentation of the coverage issue was fairly comprehensive, and that he would try to complement and supplement that presentation by touching upon a few factors that are particularly relevant to the Asian context. East Asian countries coped with the short-run impact of the financial crisis much better than had been feared at the peak of the crisis. Although rapid recovery of the region's economies has played a role, much of the credit for this resilience goes to the strength and depth of family and community-based social safety nets.

**122.** Nevertheless, demographic trends and globalization are forcing Asian countries to move toward more formal social safety nets. The emphasis here should be on improving the income-generating capacity of the poor, and to help the general population to deal with a wide range of risks in order to attain an adequate retirement income. Also, social security reforms are essential for re-establishing strong and sustainable economic growth. That is, improving and strengthening social safety nets is a high-priority task even in terms of efficiency. However, social safety net reforms are not likely to be smooth or rapid due to political difficulties, as well as institutional and regulatory inadequacies.

**123.** East Asian countries could strengthen their institutional capacity to design and implement social safety net programs, including pension reforms. Policymakers and the general public of East Asia may have to undergo two important changes in their mindset in order to achieve this. First, they need to regard social protection policies as an integral part of economic management in this age of globalization. Secondly, they need to regard socio-economic information as a public good rather than as a resource to be used for strategic advantage.

**124.** Dr. James shared Professor Asher's view that Dr. Holzman's presentation of the coverage issue was quite comprehensive. However, Dr. James took a more skeptical view of the appropriateness of universal schemes as a means of helping the uncovered and expressed her view that assistance should be targeted toward the most needy groups. Dr. James concentrated her comments on two core issues: social assistance and assistance for women.

**125.** Social assistance is essential but there are implementation difficulties. There is a tradeoff among expenditures on social assistance, employment generation, and education and public goods. Within social assistance, one has to distinguish between benefit criteria for the old and the young. The key difference between the two groups is that work incentives are less relevant for the old.

**126.** The implementation of means-testing involves a number of different issues, including: (i) how to keep both formal and informal (e.g. corruption) transactions costs low and leakage to a minimum; (ii) how to determine eligibility (e.g. neighborhood basis); (iii) how to avoid moral hazard such as discouraging savings and corruption; (iv) should in-kind transfers such as free lunch or dormitory-style accommodation be provided to promote self-selection; and (v) how can the family-support system be maintained rather than crowded out?

**127.** Special provisions are required for women who have not worked enough to be eligible since they represent the largest uncovered and hence most vulnerable group in the population. Their vulnerability stems from their greater longevity relative to their working spouses, the possibility that retirement savings may be used up, and their lower eligibility and benefit levels stemming from the division of labor with their spouses in which they produce homemaking services. There is a potentially serious problem of poverty for women if the family-support system breaks down before more women participate in the labor force.

**128.** Possible solutions to inadequate coverage for women include requiring spouses to buy survivors' benefits both before and after retirement, and universal benefits for widows. If a spouse is covered by DB pensions, an option may be to split the pension between the spouses. If a spouse is covered by DC pensions, one possibility is to require joint annuities. But there are still many uncovered spouses. Support for women is a spousal (family) responsibility and the government is at best a helper of last resort. Therefore, it is particularly important for women that any formal support does not "crowd out" family support. Dr. James finished her talk by noting that there are more questions than answers in the area of providing for women, and that this area remained ripe for further study and more innovative solutions.

**129.** Resource speakers shared thoughts with the participants about various issues relating to pension reforms and poverty alleviation. The issues include the effectiveness and efficiency of different pension systems on poverty alleviation among the elderly; the differences between universal systems and means-tested systems; Asian attitudes toward pensions as a means of retirement consumption; the conflict between immediate access to pension balances and future need for retirement resources; and the need to educate the general public about the necessity of saving for old age.

**130.** **Dr. Rajat Nag**, Manager, Energy and Financial Sectors Department, ADB, and **Dr. Robert Holzman** talked about the ***Multilateral Institutions' Approach to Asian Pension Fund Reform***. They emphasized that the approaches of the ADB, World Bank and other institutions were essentially similar. Dr. Nag began his talk by noting that multilateral institutions have become increasingly interested in pension reforms in the 1990s, moving resources into this area, especially institution-building. This reflects a growing awareness that informal old-age support is being eroded due to demographic trends and changing values.

**131.** The Asian economic crisis has exposed significant weaknesses in social protection as well as financial market development. A modern economy does not provide the informal social insurance that agriculture and self-employment does in an informal economy. The financial crisis and its root cause – over-dependence on foreign short-term funds and weak domestic banking systems – has highlighted the need to build up long-term sources of finance in order to support financial stability. Asia has been good at saving, but poor at investing those large pools of savings. Pension fund reforms can help rectify this by promoting financial development.

**132.** ADB does not have a one-size-fits-all approach to pension reforms in Asia. The approach for each country depends on: (i) political and macroeconomic considerations; (ii) risk of breakdown of the informal system; (iii) the nature of existing old-age support systems; and (iv) status of development of financial markets. ADB's overall pension reform objective is to balance social equity with efficiency considerations while avoiding fiscal unsustainability and trying to support complementary capital market development. In practice, this means that ADB generally recommends a move to a three-pillar system consisting of (i) minimum social assistance, (ii) mandatory funded DC component, and (iii) voluntary funded DC component. The pace and sequencing of reform varies from country to country. The ADB provides a variety of technical assistance, including diagnostic assistance, system design, institutional development, administrative reform, public and market-participant education, capacity building, and financial market development. Dr. Nag expressed his view that pension reforms are complex and difficult but, at the same time, also feasible financially and politically.

**133.** Dr. Robert Holzman talked about the challenges and opportunities for pension reforms in Asia. Dr. Holzman noted that in Asia there are often formal provision systems for only a minority, i.e. those in the formal sector. For these systems, it is difficult to increase coverage rapidly. It is also problematic to make sure that they do not take up too much fiscal resources and thus create a heavy implicit pension debt, distort savings and labor supply decisions, and make sure they contribute to financial market development. Dr. Holzman noted that Dr. James earlier discussed voluntary provisions for the majority who are in the informal sector (the future poor). A third strategic view on retirement support, other than formal provisions and voluntary provisions, concerns providing public support for those who are currently poor and old.

**134.** Opportunities for Asian policymakers in designing or reforming their pension systems include avoiding the mistakes made by other countries in the world. Examples include adopting an integrated view and avoiding fiscal unsustainability. At the same time, there is ample scope for innovation and experimentation. Examples include moving toward a multi-pillar structure (still rare in the world), and taking new approaches to expanding coverage and reducing administration costs. Finally, decentralizing pension fund management and supporting the provision of new financial instruments such as market-priced government bonds are but two examples in which the government can foster financial market development in connection with pension fund reforms.

**135.** Dr. Holzman concluded by outlining the World Bank's approach to pension reforms. First, there is no World Bank blueprint for reform. The World Bank generally supports a multi-pillar structure but does not force this upon countries. Rather than the adoption of a specific structure, it is more important that reforms focus on ownership and credibility. Second, while there are no blueprints, there are certainly criteria for deciding whether a reform program is sound or not. These include redistributive criteria, the soundness of macroeconomic and fiscal policies, and the adequacy of the administrative structure. Finally, the World Bank's approach also involves linking client assistance with knowledge management, implementation support such as regional workshops, encouraging the research agenda, and strengthening partnerships with the IMF, regional development banks and other international institutions. Dr. Holzman concluded by noting that in the area of pension reforms, whether in Asian or elsewhere, there are more questions than answers but a good point of departure is always to begin by asking the right questions.

**136.** The post-presentation discussion between the resource speakers and the participants centered on directly persuading politicians about the need for pension reforms; doing so indirectly by educating the general public and thus creating pressures on politicians; promoting transparent public debate and inter-ministry coordination on pension policy; and the invalidity of the one-size-fits-all approach to reform in different countries.

## Conclusion

**137.** On the final day of the workshop, the attending officials from the pension-related government agencies gave brief but informative **country reports** about the major problems and solutions regarding the pension systems of their respective countries. Some problems that emerged during the reports include: inadequate coverage, over-generous public sector pension benefits, low rates of compliance in mandatory private-sector systems, inequality of contributions and benefits, low rates of return, weak legal systems and institutional framework, and the general public's lack of awareness about the importance of retirement provisions. Some solutions that came out during the reports included raising the retirement age, reducing benefits and raising the contribution rate, diversifying and outsourcing of fund investment, extending coverage to currently uncovered sectors, educating the general public, integrating the public and private systems, and strengthening the legal, regulatory and institutional infrastructure.

**138.** Professor Asher and Dr. James provided some general comments in an exchange of views with the presenters during the reports. They noted that it is impossible to extend coverage without improving compliance, and it is important to minimize administrative costs. They also agreed that investment policies should be based on realistic assumptions. Dr. James observed that even currently healthy systems with large reserve funds often carry large future liabilities, implying a need for accurate actuarial studies and improving the rate of return for fund investments. Dr. James also noted that even when administrative costs are high as a percentage of new contributions, they might not pose a problem if they are moderate or low as a percentage of total assets. With respect to administrative costs, Dr. Asher emphasized that pension systems should economize as much as possible given the circumstances they face, since such savings drive up the rate of return for the pensioners.

**139.** **Dr. Raj Chhikara** from ADB Institute informed the participants that the two main follow-ups to the Workshop would be: (i) an executive summary of the workshop's proceedings to be prepared by the rapporteur, Dr. Donghyun Park of Nanyang Technological University in Singapore; and (ii) the establishment of a network of those who have participated in the Workshop so as to help build up a regional network of pension reform specialists. Dr. Chhikara strongly encouraged the participants to stay in touch with one another and to bring into the network acquaintances who are interested in the area.

**140.** **Dr. Asher** wrapped up the proceedings with **two overriding themes** that emerged from the five days of presentations and discussions. First, pension reform is not a panacea for all economic problems but it is essential for maintaining competitiveness in the increasingly globalized world economy. And pension reform's positive impact on fiscal sustainability and financial market development are particularly significant in this connection. Second, pension reform is a difficult and complicated process that requires a 'systems approach' that integrates legal, fiscal, financial, social and other aspects. In this connection, a carefully planned and well thought out sequencing of reform is critical.

**141.** In the closing ceremony, **Dr. Chhikara** thanked the participants for their active and enthusiastic participation. He also expressed the hope that the conceptual training as well as the practical skills the participants had gained during the workshop would help them design and implement more effective pension systems in their respective countries. **Mr. Anthony Chng Chye Tong** congratulated the participants for successfully completing this intensive workshop.