Zamani Abdul Ghani: Reinventing retirement strategies in the new world of risks

Keynote address by Mr Zamani Abdul Ghani, Deputy Governor of the Central Bank of Malaysia, at the 4th Asian Conference on Pensions & Retirement Planning: "Reinventing Retirement Strategies in the New World of Risks", Kuala Lumpur, 26 November 2007.

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Introduction

It is my great pleasure to be here today at the 4th Asian Conference on Pensions and Retirement Planning. Let me first extend a warm welcome and Selamat Datang to all the participants from abroad and fellow Malaysians here today. During this "Visit Malaysia Year", which is also the year Malaysia celebrates its 50th year of independence, I do hope our foreign participants will make time to enjoy Malaysia's diverse culture, and experience the many unique sights, sounds and flavours, as well as discover why Malaysia is “truly Asia”.

I am indeed very pleased to be invited by the Asia Insurance Review to address this major Conference. This Conference brings together both experts and learners who all share deep interests in the development of the pension and retirement planning. I was told that we have amongst us today distinguished market practitioners and participants from the insurance and banking industry, regulators, pension providers, consultants, and investment managers from 17 countries. I wish to congratulate the Asia Insurance Review for bringing together such a gathering here in Kuala Lumpur , and organizing this Conference for the fourth consecutive year.

The theme for this year's conference, "Reinventing retirement strategies in the new world of risks" is most appropriate and relevant to Asia . As we are aware, the ageing population is also an issue in this part of the world. Statistics have indicated that worldwide, a greater number of people are reaching old age and living longer than before. For Asian countries, the World Bank reported that by 2040, the number of the elderly will surpass the number of children and by 2050, it is estimated that there will be nearly 1 billion elderly in Asia . The increasing number of ageing population, relative to a declining workforce in Asia , would significantly increase the dependency ratio in the Asian region from approximately 10% currently to 25% in 2050. Some Asian countries' dependency ratio is expected to reach even as high as 70% in 2050.

Malaysia too is not spared from this worldwide phenomenon. The proportion of Malaysians age above 60 is expected to be more than doubled from 7% of the total population in 2000 to 16% in 2020. With improved standards of living, life expectancy is expected to further increase to 79 years for females and 75 for males. By 2040, therefore, one fifth of Malaysians are expected to be in the more than 60-years age bracket. During the same period, the ratio of population between the ages of 15 to 60 years is expected to increase albeit at a slower rate until 2020, and then decline to form about 63% of the population in 2040.

The increase in life expectancy, or longevity, is very much attributable to advances in medical science and technology, as well to improved access to such facilities, resulting in a steady rise in the average age of the population throughout the world. This trend, and the falling of fertility rates, perhaps due to urbanization and higher number of working women, has long been experienced by the developed countries and is rapidly emerging in the developing economies.

This demographic change has also brought with it an observable change in the social values of societies. The World Bank estimated that currently, about 74% of the elderly in Asia is being supported by, and live with their children or grandchildren. This finding is also

consistent with a recent survey conducted in Malaysia which revealed that 67% of retirees' main source of income originated from their children. This **"extended family"** factor has often been quoted as the reason why retirement planning may not really be necessary in Asia . However, findings from the UN suggested that, as countries mature and develop, an increasing number of elderly are left to fend for themselves without their children's or family's support. This shift is seen as a form of natural adjustments, when the population in general embraced increasing progress and that a fast changing modern environment requires precious resources to be well spent in a short period of time.

Premised against these demographic and societal value changes, many countries worldwide have placed greater effort and emphasis in reviewing the sustainability and long-term affordability of their pension systems, culminating in several reforms to their pension structures. The reforms are in fact inevitable, as most of the existing public pension schemes, whether pay-as-you-go (PAYG) system or a fully funded system, were ill-designed to deliver fair benefit levels to pensioners in the future. This is so as they were originally crafted without taking into account the demographic and socio-economic changes that are being seen today.

In reformulating retirement strategies, therefore, due emphasis must be given to several main challenges, foremost being **longevity risk** posed by an ageing population. A majority of pension schemes are built on the premise that the government is able to support the defined benefit pension payments as and when they become due. In simple terms, this essentially means that I will be financially taken care of by the government when I'm old. However, this notion may not be financially sustainable anymore as most pension schemes have not imputed the impact of longevity risk at the outset. Longevity had resulted in a higher number of retirees drawing pension benefits vis-à-vis the gainfully employed tax-paying persons, thereby contributing to untenable fiscal deficits. In response to this challenge, some countries are shifting towards the **defined contribution (DC) schemes** . However, while a DC scheme could address the issue of sustainability, it would not adequately cater the need to provide a stream of benefit payment throughout the lives of retirees, especially for those who outlived their retirement savings.

In Malaysia , for example, most of those employed are mandated to contribute to a defined contribution (DC) scheme known as the Employees Provident Fund (EPF for short). A recent survey conducted revealed that a bout 72% of EPF contributors spend their entire EPF savings within 3 years of retirement, i.e., by the age of 58, an average retiree would have all his retirement savings depleted. In the case of a man, he has to be financially self-supporting for the next 17 years of his life, assuming he lives till 75. Presumably, his retirement needs will be met by family members. However, with diminishing "extended family" values, it is uncertain if this will eventually happen.

Another significant challenge is to modify the **structure** of mandatory pension schemes itself, of which many are based on a full-time employment model. Most countries in this region do not have extensive pension schemes to cover both the formal and informal sectors. I understand that in Thailand and China , for example, only about 4% and 60% of the labour force is respectively covered. The full-time employment model does not adequately address the profound changes in employment patterns, which economies are now experiencing, such as the increasing number of women in the workforce.

Then again, most pension schemes are also designed for workers with full and uninterrupted careers. This does not reflect the experience of women, as we see more and more today, who may leave their jobs to become full time housewives or homemaker. Breakdown of marriage institutions, which is now not uncommon, and the fact that women typically outlive their husbands, place women at greater risk of being in poverty in old age unless pension schemes are adapted to meet their needs. Pension schemes must also take into account the changing work patterns in economies, which in the recent decade had seen an increase in part-time workers, the self-employed and temporary workers.

The third challenge is in instilling **public awareness** on planning for retirement, particularly on having an appropriate level of retirement income to support retirees' healthcare and long-term care. A recent survey conducted in Malaysia revealed that more than 80% of Malaysians are either indifferent or not worried whether or not they have enough money for retirement. Only 34% are consciously saving regularly for retirement and an alarming 60% do not know exactly how much they need during retirement. In this regard, there is a significant role for key stakeholders, including industry players, to educate the public to be more responsible for their retirement needs, enhance understanding of the risks faced by retirees and design products and services that provide long term financial security for the retirees.

Another major challenge facing pension systems is the implication of financial market environment on pension **investment strategies** . While the demand for savings and retirement products exert growing influence on financial markets, subsequent falls in asset prices have led to wide-spread funding pressures in the past for most pension systems. This was exacerbated by the limited supply of financial instruments to meet the long-term liabilities of pension funds leading to asset liability mismatch and enhanced exposure of the fund to short-term price volatility.

Another observation worth highlighting under the current pension setup in most jurisdictions is the absence of a **single regulatory body** to oversee the functions of an effective and efficient pension delivery system, both public and private. The absence of a single regulatory body has its list of drawbacks such as impeding the development of market infrastructure, the ability to conduct effective oversight of the providers' performance and strategies and monitor the investments made by pension funds. A pension industry that is not cohesively governed may result in duplications and unnecessary administrative cost. Hence, to strike a balance between achieving goals of market efficiency and reducing contingent fiscal liabilities, while promoting appropriate social benefits, may warrant a singular and unified approach under a single regulatory body.

Amidst such challenges, there have been substantial reforms to pension systems in recent years to avoid systemic risks implications to financial stability and fiscal sustainability. Allow me to briefly outline the reforms undertaken by various jurisdictions. One of the most common features of reforms involves raising the age at which eligibility of benefits can occur. For some, especially in European countries, large tax increases were introduced as an alternative to address serious problems of financing pension benefits. In countries with severe demographic challenges, pension benefits were reduced by way of indexing benefits to wages and consumer price indices. Essentially, much of the pension reforms were focussed on reducing fiscal deficits.

However, the impact of such reforms has achieved varying degrees of success and in some cases has been noted to have regressive effects. While it is not expected that all countries may make similar choices, striking a balance between maximising returns on pension fund investments and ensuring stable retirement incomes may result in trade-offs that could compromise other developmental needs. For example, poor investment returns on asset classes arising from funded pension schemes may require the Government to secure alternative funds to provide sufficient returns for the workers making such contributions. This could potentially stifle the development of other sectors in the economy.

Moving forward, the challenge is to provide sufficient, affordable, sustainable and robust pension schemes. In this connection, I will attempt to raise pertinent initiatives that will accord the opportunity for us to discuss and develop coherent and converging solutions which are both effective and timely.

Firstly, the design of a suitable policy framework to provide incentives for more stable long term savings that could negate the effects of reducing living standards after retirement and fiscal strains in the government budget. In this regard, there is a strong need to pursue measures to incentivise and marshal long term savings without making it compulsory, a worthwhile effort in the wake of managing retirement risk implications. The measures involve

raising financial literacy and public awareness of the perils of the aging, describing the uncertainties of health care and the limited capacity of government funded schemes;

Secondly, with the increasing demand for suitable financial instruments to hedge long-term liabilities and with increased emphasis to strengthen asset-liability management practices to meet projected obligations, further development of the financial instruments that facilitate risk management is therefore critical. In this regard, the Government could play a crucial role in the development of financial instruments and the associated market infrastructure. For example, the issuance of large amounts of very-long dated bonds and index-linked bonds in some industrialised nations have helped mitigate risks associated with the duration gaps of asset against liability, inflation and longevity risks;

Thirdly is the careful design and implementation of an appropriate tax mechanism for pension system that will encourage greater retirement savings. Again, the role of the Government must be re-emphasized, primarily in packaging suitable tax advantages which can be offered in order to incentivise even the population outside the formal sector of employment to promote higher contributions. Some pension markets remain underdeveloped or at least underutilised in part due to tax disincentives. As such, the design and implementation of an appropriate tax framework incorporating preferential tax treatment could facilitate the promotion of long-term savings.

The problems experienced in recent years by public funded pension systems highlighted the importance of complementary or supplementary forms of private savings initiatives. The emergence of institutional investors in particular, primarily as risk transfer conduits and as collectors of savings has shifted focus from publicly funded pensions systems to private savings schemes. This is the fourth and last initiative I will attempt to raise.

In order to reduce the cost of providing for the social security of the ageing population, developed countries have encouraged the development of private pension schemes through tax incentives. In some developed countries, employees are given higher personal tax relief for contributions to approved pension schemes. While some countries have made private pensions mandatory, others continue to grapple with ways to promote participation in private pension systems in order for households to meet adequate retirement income needs. As such, measures need to be taken to incentivise private pension schemes. The enhanced savings intermediation could, to a large extent prompt the development of a more diversified financial system which would be less reliant on banks and consequently help reduce the overall risk of contagion.

The past decade has underscored the importance of pension systems to the economic stability of countries and the security of their ageing population. The experience with reforms has also shown that no one size fits all, that countries have different combinations of the elements of an effective pension system to consider depending on their individual circumstances. However, what remained relevant are the two broad aims of any pension system, that is to reduce poverty and eliminate the risk of rapidly falling living standards in retirement. In this regard, The Multi-pillar Pension Framework as advocated by the World Bank would be a good guide to mobilize both the Government as well as the insurance industry to develop a sustainable pension system. The application of the reform framework nonetheless requires a combination of measures that include effective fiscal policy and incentives as well as the development of the capital market so that the collective outcome is effective in its entirety.

On that note, I wish you all success and may you have a productive and fruitful conference. Thank you.