Asia Pacific’s Pension Market Revolution

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Asia Pacific is home to some of the largest pension funds globally, with eight of the largest 20 worldwide based in the region. Traditionally, when compared to North America and Europe, the Asia Pacific pension market has a perception of being underdeveloped, overregulated and too domestically focused and conservative in their asset allocations. This may have been an accurate description in previous years, but in 2010 this conjecture is clearly outdated.

In fact, a revolution of Asia Pacific’s pension fund market is gathering steam on a global level. In recent years, pension and retirement schemes have become one of the largest and fastest-growing pools of capital in the region. Given the government support, a growing population and an expanding middle class in the region, the explosion in pension assets and reform of the pension fund sector will be one of the defining moments of Asia Pacific’s ongoing investor revolution.

However, the revolution will come at different stages in local markets and will be driven by contrasting sets of issues. While greater diversification into international and nontraditional assets is core to the maturity of many national pension schemes, there are also other drivers such as risk management and cost management, which will place greater onus on global custodians to cater to demand. Given the enormous population of Asia Pacific and the desire to build contributions, the regional pension fund revolution will continue for many years and require substantial support.

The Current Environment

There are numerous factors working in favor of substantial and sustained pension fund growth in Asia Pacific. Across the region, people are living longer, which requires a higher cost of financing for retirement. Additionally, the population across the region is growing; estimates by the United Nations suggest it will be over one billion by 2030. Mass urbanization in the region will also continue and has highlighted the need to expand national pension schemes to cover a greater segment of the population.

Simply put, these factors add up to two clear conclusions for Asia Pacific’s pension fund market. First, the number of beneficiaries will increase. Second, the need to manage costs, risks and maximize returns on contributions will be pivotal to the long-term plans of national pension services.

Currently, there are more than 150 pension funds in Asia Pacific. Assets under management stand at over $3 trillion, which is roughly 15% of the $23 trillion globally, according to Towers Watson’s Global Pension Asset Study 2010. The number of funds in the region is expected to grow dramatically in the coming years, but there will be different motivations and contrasting asset realignments to support the expansion of assets in Asia Pacific’s pension fund chest.

China and Korea

To best illustrate the continual development and evolution of the pension fund industry in Asia Pacific, China and Korea are two of the more prominent examples of how this sector is developing in the region. Similar to long-established markets such as Australia and Japan, the pension markets of both China and Korea have made great strides in recent years, in terms of increasing the number of beneficiaries and augmenting contributions. With supportive regulatory environments and an eye to optimizing returns for a growing and aging population, both markets are poised to become major pension markets in the coming decade. However, they are at different stages of development and are growing for different reasons.
The creation of a national pension fund in China had been identified as a pivotal governmental project long before the establishment of the National Council for Social Security Fund (NCSSF) in 2000. Since the launch of the market-oriented fund, which is allocated revenue by the government and 10% of total proceeds from initial public offerings of state-owned enterprises, the capital pool has grown to RMB776.5 billion ($114 billion).

Compared to other national pension funds in Asia Pacific, the NCSSF trails significantly in terms of assets. Given the number of aging beneficiaries and the immense population of China, this paradox is not lost on the NCSSF board.

In March 2010, the NCSSF declared it wanted to increase its total assets to RMB 2 trillion (approximately $300 billion) by 2015 and that it would need to realign its investments to achieve this. To meet this goal, the NCSSF has publicly stated that it will expand its overseas investment and look at unorthodox options, including private equity funds.

Korea’s pension sector is in a slightly different situation to China. The country’s population is relatively stable and its various national pension schemes are long established and well capitalized. Combined, Korea’s domestic pension plans currently hold over $300 billion in assets under management, making it the third-largest market in the region after Japan and Australia.

Korea’s domestic pension fund sector is dominated by the National Pension Service (NPS) which, with assets of approximately $260 billion, stands as the fourth-largest pension fund globally. As has been well reported, the NPS issued a defining mandate in 2007 declaring its intent to quadruple its offshore investment stake by 2012, which currently stands at approximately 10%.

While not facing the challenges of China’s NCSSF, the NPS’ move has evidently signaled its desire to diversify holdings away from its traditional domestic fixed income investments to spread risk. Additionally, the move by the NPS is seen by many as promoting Korea’s role as a serious institutional investor on the global stage.

Although enhanced yield lies at the core of the offshore ambitions of China and Korea’s national pension funds, the end results for both nations differ. This scenario is playing out across the region in other markets such as Taiwan, Malaysia and Singapore, where national pension funds are diversifying investments to not only cover beneficiaries but to also spread risk, drive down costs and gain exposure on an international level.

Supporting the Momentum in Asia Pacific

While the strategies, future ambitions and schemes of pension funds in Asia Pacific vary significantly, as illustrated by the China and Korea models, there are implications for external parties in the region. Specifically, as increased offshore investment and asset diversification by pension funds in Asia Pacific gain momentum, the expectations of providers, particularly global custodians, will change, not just in terms of credit ratings. In our experience, we have identified several areas where global custodians will need to focus to match expectations, regardless of the plans of pension fund clients.

First, for global custodians to best serve pension fund clients, a closer relationship with investment consultants is clearly required. With greater asset diversification, enhanced focus on risk management and cost management driving many pension funds (as in the case of China and Korea), investment consultants are pivotal.

The number of investment consultants in Asia now including custodian evaluation and selection services has increased. Consultants play a pivotal role in establishing communication flows between pension funds, external fund managers and global custodians. Global custodians ensure seamless account setups in multiple markets, and instructions flows between these three parties. The ability to establish this service structure for a pension fund through its own network should be a consideration for pension funds in Asia Pacific looking to appoint a global custodian.
In addition to the traditional fixed income, equities and cash, as more pension funds increase allocations to a greater variety of assets, such as private equity investments, alternative funds, real estate and illiquid instruments, the ability to provide accurate and efficient consolidated valuations will become a key requirement.

Second, as they evolve further, pension funds in Asia Pacific are turning to global custodians with transition management, commission recapture and securities lending capabilities. For portfolio realignments, an increasingly common theme as pension funds diversify assets, an in-house transition management capability has become key in appointing a global custodian in Asia Pacific.

Similarly, as global markets remain volatile, securities lending schemes that provide for efficient recall procedures and address market-wide concerns of cash collateral have been used by a broad range of funds in Asia Pacific. As restrictions on short selling are lifted in markets such as China and India, pension funds will clearly utilize securities lending programs even more, which can be managed in partnership with global custodians.

Finally, as the number of beneficiaries, schemes and total assets expand, efficient administration of benefits, contributions, employee payroll and other payments through centralized secure, prompt and accurate domestic and cross-border payments will become more critical, as will receivables solutions and prepaid cards, which will become a medium to effecting secure disbursements to beneficiaries.

To enhance cash flows for working capital requirements and to improve returns on surpluses, many pension funds in Asia Pacific are now utilizing daily sweeps into high-interest accounts and the liquidity investment platforms offered by banks. Global custodians with a robust cash management platform that can provide comprehensive securities, funds and cash solutions, as well as transition management, commission recapture and securities lending to contain administrative costs, with easy-to-use web applications, accurate reporting and competitive foreign exchange rates, will be well positioned to meet the growing requirements of pensions in Asia.

To optimize yield, many pension funds in Asia Pacific are now utilizing daily sweeps into high-interest accounts and associated liquidity management. In our experience, custodians with a robust cash management platform will see increased business as a result of the risk management drive by pension funds in Asia Pacific.

The decision by national pension funds in Asia Pacific to diversify asset allocations, as illustrated by the China and Korea examples, depends on the fund’s individual motivations, be they yield enhancement or risk mitigation. Their success will be defined by their ability to evolve their investment strategies to address demographic changes and balance national interests and market movements, albeit at different levels of pace.

Given the increasing and aging populations, urbanization in emerging markets and the drive toward more universal coverage, the pension market in Asia Pacific is large, diverse and poised for further growth, as is the enhanced set of solutions that will be required to support this huge asset base.