Pension reform paves the way for target-date funds in Mainland China

By Nixon Mak

In brief

China wants to develop its private pension market. To this end, the government favours a system based on fund of funds (FoFs) or other vehicles that pursue only target-date, target-risk or other strategies approved by authorities. We expect that target-date funds in particular will become popular, with an expected market size of up to RMB 1.88 trillion (USD 280 billion). Socioeconomic trends will provide the impetus for rapid market growth over the next 10 to 20 years.

China has recently introduced guidelines on retail pension target funds, marking a key milestone in the development of the mainland's commercial pension system and asset management industry. Together with a team of students from the Cambridge Judge Business School's Master of Finance programme, Invesco studied the impact of these guidelines.

China's pension system rests on three pillars: a government-run basic pension scheme, an enterprise-run annuity scheme and individual commercial pension schemes (figure 1). Currently, this third pillar comprises retirement insurance plans and retirement investment products, or pension target funds. Chinese policymakers are attempting to reinforce the third pillar since the first two are facing increasing strain.

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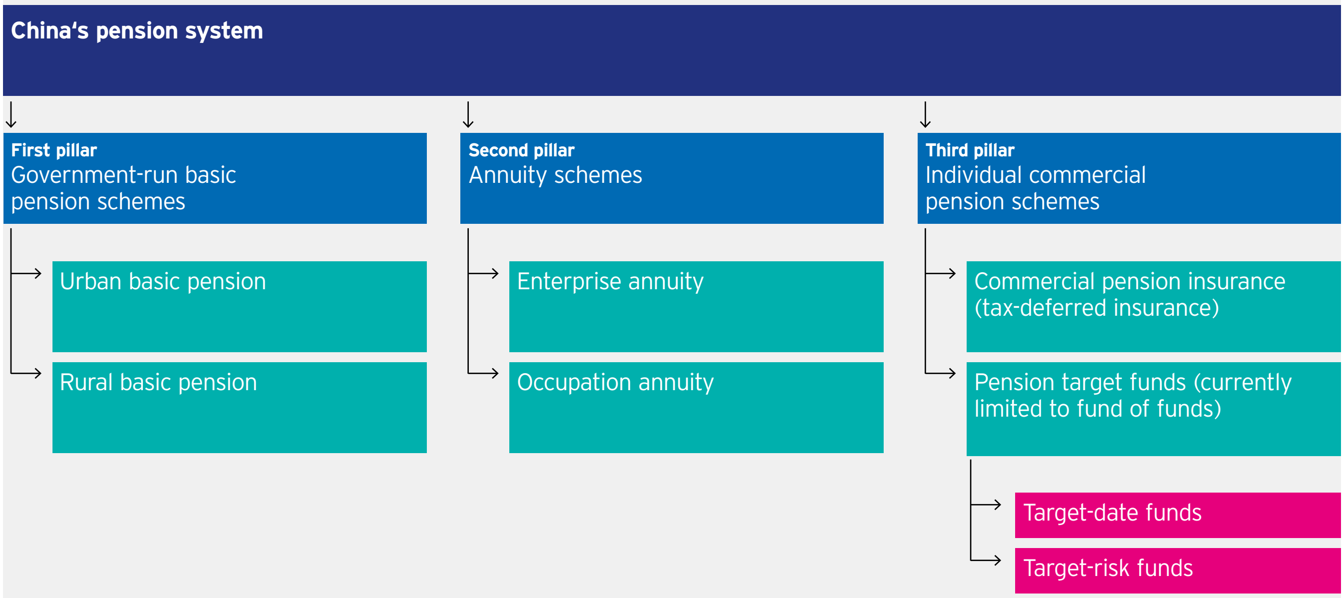
Figure 1
The three pillar structure



Source: Invesco, as at 3 January 2019.

Table 1
Recent developments in China's individual commercial pension segment

June 2017	March 2018	May 2018	August 2018
State Council provides guidelines for new commercial pension insurance products.	CSRC introduces guidelines on pension target funds.	Tax-deferred insurance pilot project launched in selected cities.	CSRC approves the launch of pension funds in the form of fund of funds.

Source: China Securities Regulatory Commission (CSRC), as at 30 October 2018.

One of the new guidelines for individual commercial pension schemes (table 1) is the China Securities Regulatory Commission's (CSRC) guidance on their structure: they should be constructed as FoFs and pursue target-date strategies, but also target-risk or other concepts approved by the CSRC.

The CSRC's preference for a FoF structure comes as no surprise since pension investments should place more emphasis on risk control than on the pursuit of returns. As a combination of funds, FoFs can offer investors a more diversified portfolio and reduce exposure to any single asset or risk.

In our view, the CSRC's approach is well-thought out, as it speeds up the development of the third pillar of China's pension system. By constructing FoFs, fund providers can use already existing products and combine them under a pension wrapper. This reduces the administration needed.

Estimating the size of China's target-date funds market

Among the different types of FoFs, we believe that target-date funds will become popular in China over time. They follow glide path structures that rebalance their allocations, so as the target date approaches, they focus less on growth and more on income. Even investors without in-depth financial knowledge should find them easy to understand, which makes them attractive for retirement planning.

We believe that target-date funds will become popular in China over time.

But how big can the market become? The mature US pension market, where target-date funds are very popular, may give an indication: over the past 10 years, US target-date mutual funds have received net inflows of USD 521 billion.[1] They ended 2017 with assets of USD 1.1 trillion, an increase of USD 229 billion, or 25.8%, from 2016.[2]

In estimating the potential size of China's target-date funds market, we referenced publicly available data to determine the number of people who would likely invest in such funds.[3] For the lower bound estimate, we looked to the number of people under enterprise annuity schemes. Since the employer's contribution is forfeited if one leaves, we think these people (23.31 million of them) are most likely to invest in tax-deferred pension products.

For the upper bound estimate, we referenced another government report on the number of people contributing to the Housing Provident Fund.[4] Monies contributed to the fund can be used to purchase housing or pay rent. The contributions are also matched by the employer and, since it counts towards income tax relief, people tend to contribute the maximum amount allowed. There are currently 130.6 million people contributing.

As for calculating how much each individual is willing to contribute per month, another report noted that an individual is willing to contribute RMB 400 monthly into a pension plan if there are tax deferment benefits. Using RMB 400 as a base case scenario and RMB 1,200 as the upper bound, we calculated that the target-date funds market would reach a

Table 2
Estimating the potential market size of target-date funds in China (volume per annum, in RMB billion)

		Additional contribution in RMB per person per month				
		400	**600**	**800**	**1,000**	**1,200**
Participants (million)	**23.31**	112	168	224	280	336
	32.66	157	235	314	392	470
	65.32	314	470	627	784	941
	97.98	470	705	941	1,176	1,411
	130.64	627	941	1,254	1,568	1,881

Source: Calculated by Invesco, as at 3 January 2019.

volume of at least RMB 112 billion, and could become as large as RMB 1.88 trillion (USD 280 billion, table 2).

What may prevent the market from achieving full potential?

The market still needs to overcome some limitations before it can achieve its full potential of RMB 1.88 trillion.

Currently, for instance, there are restrictions on who can qualify as a fund provider, the underlying fund sizes, the use of derivatives and access to foreign markets. These factors limit the number of fund houses that can offer such products.

At the same time, target-date funds still do not enjoy tax incentives. China recently rolled out a one-year tax deferment pilot scheme for pension insurance products. Given that the pilot was only introduced in selected cities, we would need to wait for detailed findings to determine whether the tax deferment scheme was helpful in promoting pension insurance products to the public. The pilot is set to end in May 2019.

Should the pilot for pension insurance products turn out to be a success, there is a chance that authorities would extend tax deferment benefits to pension target funds. Having similar tax deferment benefits will no doubt aid in the target-date funds market's long-term development. Officials have also talked about applying a default investment mechanism, much like how the US enables automatic enrollment into target-date funds for employer-sponsored retirement savings 401(k) plans. We look forward to more policy developments in China on tax incentives for pension target funds.

Aside from policy hurdles, there are also some market dynamics that weigh on the market's growth potential (table 3). For example, awareness is still lacking when it comes to retirement planning in China. A survey conducted in 2017 showed that only 9% of 2,013 respondents across several Chinese cities say that they are "very involved" in monitoring and managing their retirement savings.[5] At the same time, banks are the primary channels for fund distribution in China, and they may prefer distributing mutual funds over FoFs due to mutual funds' relatively simpler structures. In addition, FoFs' key selling point

Table 3
Limitations on China's target funds market development

Issue		US	China	Analysis
Developing asset management industry	Underlying fund size	No limit	Average net asset value of at least RMB 200 million in the past two years	Short-term bottleneck, but expected to improve
	Use of derivatives	Allowed	Not allowed	Derivatives market in China likely to develop, hence may not be a critical issue considering long lifespan of target-date funds
	Access to foreign markets	Allowed	Theoretically possible via products for Qualified Domestic Institutional Investors (QDII), where approved domestic institutional investors can invest in foreign products	Difficult to achieve in China at present stage
Policy support	Policy support	Default investment option for 401(k)	None	Chinese individuals would have to purchase target-date fund on their own initiative
	Tax incentives	Tax deferred	None	Beijing introduced tax deferment policy for insurance schemes likely to be extended to target-date funds to ensure fairness and competitiveness
Distribution	Distribution	Varied	Through banks, security companies, third-party independent channels	- Current market structure favours large institutions who dominate fund sales channels - Fintech platforms offer a chance to open new banking and sales opportunities

Source: Invesco, as at 3 January 2019.

of broad diversification and lower risk may also work against them – as they can find it difficult to outperform specific markets or funds with a narrower focus.

Nevertheless, we are confident that proper, sustained and widespread dissemination of retirement planning information will help to resolve these issues so that the target-date funds market can organically develop.

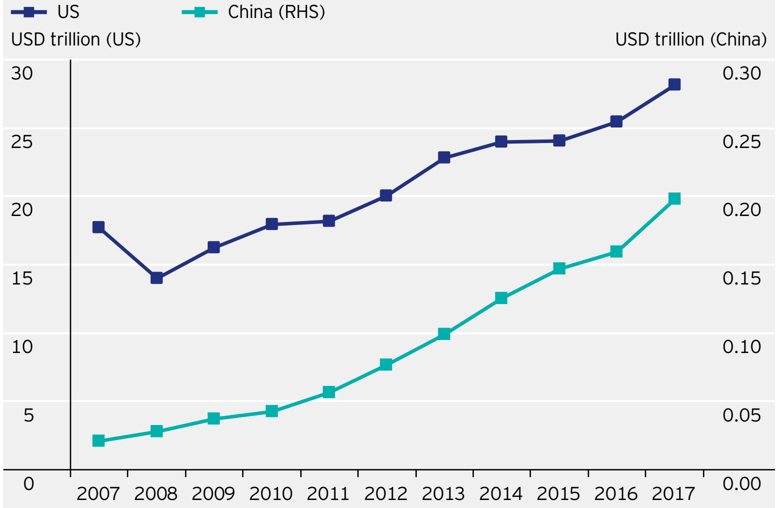
Broader trends will drive growth
Our expectation that China's pension target fund market will grow is also supported by some broader trends. In fact, we think it may even grow beyond the upper bound of our initial analysis. Once again taking the US as a proxy, we expect China's target-date funds market to see the same pace of development and grow rapidly over the next 10 to 20 years.

Our expectation that China's pension target fund market will grow is also supported by some broader trends.

A major driver of this expansion will be growing affluence in China, where disposable income per capita is rising faster than GDP, registering a compounded annual growth rate of 7.24% from 2013 to 2017.[6] As Chinese households grow richer, they are likely to shift from savings to investments as a means to preserve or increase wealth. In 2017, US private-pension plans held assets totaling some USD 28.17 trillion, representing 145.3% of the country's GDP (figures 3 and 4). For China, private-pension plans only hold USD 197.8 billion in assets – or 1.6% of GDP.[7] Thus, there is plenty of room for the target-date funds market to grow.

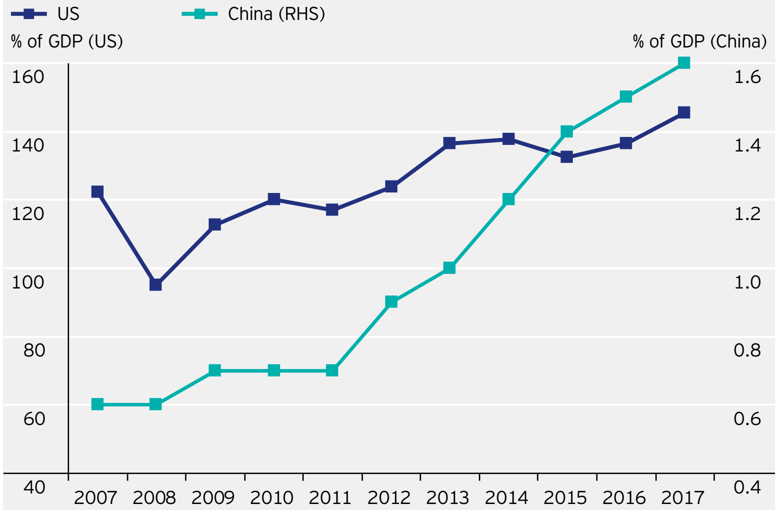
Demographic trends will also fuel this expansion. At the end of 2017, China's elderly dependency ratio was at 15.9%, almost a full percentage point higher than 2016's ratio of 15%.[8] China's retirement needs will therefore intensify, and the pension system must be able to cope with them.

Figure 2
Pension funds' assets (2nd and 3rd pillar)



Source: OECD "Pension Markets in Focus 2018". Annual data as at 2017.

Figure 3
Total pension funds' assets (2nd and 3rd pillar)



Source: OECD "Pension Markets in Focus 2018". Annual data as at 2017.

Parallel to these trends is the growth of China's capital markets. We note Beijing's recent efforts aimed at improving its capital markets and asset management sector. At the same time, asset managers' keen interest in providing FoFs underscores their confidence in the growth of China's individual commercial pension market. We believe that, in due time, there will be more and more financial products that will help in the further development of China's target-date funds market.

We expect to see the emergence of new investment opportunities.

Conclusion

Recent guidelines issued by Chinese authorities in March 2018 have opened the market for pension funds in the form of FoFs. We believe that target-date funds will prove to be among the more popular products and foresee socioeconomic trends giving the market a further boost. Continued policy reforms are likely to help the market grow rapidly over the next one or two decades. As such, we expect to see the emergence of new investment opportunities.

About the author

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Nixon Mak joined Invesco in 2016 and serves as Head of Hong Kong Pensions & Solutions Strategist, Asia Pacific. He has 20 years of experience and is now responsible for asset allocation of Invesco's Hong Kong pension and Mandatory Provident Fund (MPF) mixed-asset strategies, as well as identifying opportunities for developing new multi-asset products and solutions for clients in the Asia Pacific region.

Notes

1 2018 Investment Company Fact Book, Investment Company Institute.
2 Ibid.
3 Annual Report on the State of Human Resource and Social Security Development in China 2017, Ministry of Human Resources and Social Security, People's Republic of China (PRC).
4 National Housing Provident Fund Report 2016, Ministry of Finance, PRC.
5 The Future of Retirement in China, Society of Actuaries (US), 2017.
6 National Bureau of Statistics of China.
7 Pension Markets in Focus 2018, The Organisation for Economic Co-operation and Development (OECD).
8 National Bureau of Statistics of China, retrieved on 17 October 2018. Elderly dependency ratio is defined as the number of elderly dependents aged 65 and above divided by the number of working-age persons from 15 to 64 years old.

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