Pensions for the Bottom Billions…

by Mark Cobley, Dow Jones Financial News, 20 Nov 2013

It's a financial version of the "chicken and the egg" problem: which comes first? Capital markets, or the pension funds that invest in them?


Source: Getty Images

In the developed world, this is largely an academic question – we have both chickens and eggs, and the system works reasonably well. Even in many emerging markets – Brazil, Chile, China, India – domestic pension funds are being built up and the virtuous circle of saving and investment is under way.

But what about the world's "bottom billions" – the countries without capital markets or mechanisms for ordinary people to invest in them, and thus save for their old age?

That is where Kavim Bhatnagar, a former senior Indian civil servant now working as a consultant to Bangladesh's government, steps in. He is on a mission to take pension saving to the poorest of the world's poor, and combine it with efforts to build capital markets and financial industries in developing nations. He set out his ideas to the World Pensions Council, an industry forum, in Hong Kong this month. These include the creation of a pooled investment vehicle for developing nations, and an international centre of pensions expertise, both under the purview of agencies such as the World Bank or International Monetary Fund.

His proposals are ambitious, but Bhatnagar has experience under his belt – he helped design India's new national pension system and is now working on reforms in Bangladesh.

You might think these young, developing nations have many decades to address this. You would be wrong. While in countries such as the UK, France or Germany it took more than 100 years for the proportion of the population aged over 65 to double, places such as Iran, Venezuela and the Philippines will see that happen in the next couple of decades, according to projections from the United Nations. Bhatnagar estimates there are as many as 100 countries in the developing world with similar demographics.

But pensions coverage is alarmingly low. In the 34 developed countries that belong to the Organisation for Economic Co-operation and Development, an average 83% of the working-age population is covered by some kind of pension saving system. In other parts of the world, those numbers are much lower. In the Middle East and north Africa, it's 34%; in Latin America, 32%, and in south Asia – the Indian subcontinent and nearby countries – the figure is just 13%, according to OECD data.

Does this mean these places have no savings at all? Not necessarily. Paul Gruenwald, chief economist at Standard & Poor's for the Asia-Pacific region, points out that while assets in formal pension systems look low in many Asian countries, nations such as China have a lot saved up in banks, while people in India or Vietnam "may just be holding gold". A lack of pensions does not equate to a lack of wealth.

It is also possible to build capital markets without domestic pension savings. Turkey has reasonably well-developed markets although its domestic pension assets are just 12% of gross domestic product, according to IMF figures. But this has left the country dependent on foreign capital, which from the point of view of local politicians, can prove alarmingly mobile. This is one reason Turkey is now offering its citizens generous incentives to save into pensions.

Bhatnagar has direct experience of building up such domestic capital pools. He was working for the Indian government in 2004 when it reformed its civil service pension scheme into a defined-contribution system known as the National Pension System. As a private consultant to the government, he then worked on the extension of the NPS to non-government workers in 2009. In order to encourage the poorly paid into the system – farmers, village workers and so on – the Indian government offers an incentive of 1,000 rupees known as the Swavalamban Scheme to those who save.

In the four years since, the NPS has developed into a system with five million members and 330 billion Indian rupees ($5 billion) under management, according to the latest figures available from India's Pension Fund Regulatory and Development Authority. Two million of those are new post-2009 joiners, according to Bhatnagar, and the government's target is to sign up 20 million "informal sector" workers in the next decade.

Bhatnagar is now working on pension reform in Bangladesh, where he is a consultant to the government. He is working on a proposal to reform the existing civil servants' scheme and then extend it to the private sector – in particular the country's garment industry. He said: "But there is a problem, one we did not face in India. Where will this money be absorbed? Capital markets and money markets are not in a position to absorb it in Bangladesh."

Bhatnagar's ambitious solution is as yet on the drawing board. He said: "There could be formed a pooled investment fund under the supervision of the agencies such as the IMF, UN Development Plan, World Bank or Asian Development Bank, which ought to be pushing pension inclusion as their own mandate.

"The maximum permissible limit for a country could be pegged at 50% of its investible funds being invested through long-term internationally diversified equities, bonds and currencies." He envisages the remaining 50% of the money staying at home, to develop domestic capital markets.

Under his plan, countries that signed up to this "Pensions Convention" would have to pledge the 50% to the common pool, but could bring it back in a phased manner over the years as their domestic markets and financial institutions bed down.

The oversight of international agencies could give savers in these countries – where trust in financial or even government institutions is not widespread – confidence that their money was safe.

Meanwhile, the international centre could also co-ordinate pensions and market expertise from each country, allowing them to collaborate on policy and system design, as well as sharing technical assistance and IT support.

Sadly, governments might need some convincing. Nicolas Firzli, director-general of the World Pensions Council, said he had been "impressed" by Bhatnagar's ideas and track record, but cautioned: "It remains to be seen if governments would allow what they may well perceive as some form of 'capital flight' offshore, considering they would fund a sizable proportion of these low-cost pension schemes. "Here, western donors and supranational institutions clearly have a role to play by facilitating the emergence of shared best practices and common norms, when it comes to fostering and protecting cross-border pension investments."

Bhatnagar's ideas would take a significant international agreement – not to mention a lot of practical work. But the demographic crisis is pressing in fast, in the developing world as well as in richer nations. The problem must be tackled, and soon.