PENSIONS

Protecting retirement

China looks to third pillar to relieve financial pressure on the state

By Hui Ching-hoo

China is pushing ahead with developing its private pension market, also known as the third pillar, to ease financial burden on the state public retirement system.

The private pension market was created in 2022. Participation has been growing and product innovation has been considerable, with a wide variety of funds and tax benefits to address retirement needs.

Figures from China's National Social Insurance Public Service Platform show that as of July this year, there were 1,046 third-pillar pension products. This includes 466 savings products and 248 insurance products.

There are around 60 million individual third-pillar pension accounts and, as of June 2023, assets of third-pillar products topped 45 billion RMB (US$6.27 billion).

KPMG and the Asian Securities Industry and Financial Markets Association expect the third-pillar market to top 7 trillion RMB by 2030 and 12 trillion RMB by 2035.

According to Sherry Si, a partner at Shanghai-based YaoWang Law Office, insurance products have seen the fastest growth over the past three years. She attributes this to several key factors, including active promotion of insurers by the China Banking and Insurance Regulatory Commission because of their experience in retirement finance.

Insurance products are also typically tailored to align with individual retirement objectives, focusing on preservation of capital and value growth.

Structure

Most third-pillar products are structured as fund of funds. They are designed as target-date or target-risk funds to match the investment time horizon and risk preference of investors.

Si explains that this multi-layer approach allows investors to gain exposure to a diversified portfolio of mutual funds, helping to spread risk, reduce volatility and stabilise overall performance. For instance, target-risk funds are commonly labelled as conservative, balanced or aggressive, enabling investors to select the option that is best suited to their risk appetite.

She says target dates funds, which are similar to 401(k) lifecycle funds in the US, along with pension products featuring long-term annuity return and wealth management retirement solutions offered by leading managers such as Harvest Fund Management, are experiencing strong growth.

According to Steve Alain Lawrence, chief investment officer at Balfour Capital Group, China is looking at target-date fund markets in countries like the US and Switzerland for guidance.

"China is closing the pension financial gap by adopting the best practices from international market and tailoring them to meet the needs of its large and diverse investor base," he says.

Dependency ratio

China's public pension or first pillar system has been under financial strain since 2015 as the working-age population declines and the number of retirees rise.

The dependency ratio has dropped below 33.3%, meaning there are fewer than three workers supporting each retiree. The United Nations puts the average global old age dependency ratio at 13%-15%.

Lawrence says this is putting pressure on the pay-as-you-go state pension system where contributions of current workers are used to pay pensions to retirees, so China is accelerating development of the third-pillar market.

Government figures show that the third pillar accounted for only 0.2% of a total 13.54 trillion RMB of pension assets in 2023, compared to 57.6% for the first pillar and 42.2% for the second pillar.

Tax benefits

Buyers of third-pillar pension product buyers can benefit from tax deferrals on contributions of up to 12,000 RMB annually. According to Lawrence, the modest cap and a general lack of public awareness has limited the growth.

"Uptake is currently strongest among middle-income earners in tier one and tier two cities. Broader adoption is expected as employers incorporate these products into employees benefit packages and financial literacy continue to improve," he says.

Si points out that the attractiveness of tax benefits vary depending on several factors, including income levels and tax brackets. The higher an individual's income and marginal tax rate, the more valuable the tax break.

The risk-adjusted returns and cost structure of third-pillar products also influence investor interest. For example, she notes that some fund of funds have underperformed or have been liquidated, which may discourage risk-averse investors.

"The development of China's third-pillar system – through tax incentives, lifecycle funds and hybrid insurance products – is a vital part of the global evolution of pension systems," Lawrence says.

"Ultimately, the pension challenge is not unique to any one country; it's generational. The key to addressing it lies in coordinated public-private innovation. The boat may be crowded with pension products and product providers, but we're all rowing in the same direction."

Sherry Si

Steve Alain Lawrence