LOOKING AT INDONESIA PENSION SYSTEM
AND OPPORTUNITIES FOR CONTINUOUS TRANSFORMATIONS *)

"It's a really hard problem - the hardest problem I've considered - because it's multidimensional."

The sentence was said by the Nobel prize winner in economy, William F. Sharpe, when delivering his attention to the problem of pensions in the 67th annual CFA Institute conference forum in the year 2014.

As an organization of investment profession, the CFA Institute which has the mission "*to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence **for the ultimate benefit of society***", acknowledges that the investment industry contributes a lot in creating a public welfare. In line with the 2017 World Economic Forum report which stated a healthy pension system contributes positively on building sustainable and prospering economy, CFA Institute has put attention to the matter by publishing pensions related articles to both the Financial Analyst Journal and through its research foundation for the last 70 years, as well as launching leadership initiative called "The Future of Finance".

In the 2015 Global Market Sentiment Survey, members of the CFA Institute were asked about the most overlooked risk that posed the potential to negatively impact the global capital market in the following 5 years. The result, 20% of respondents chose the impact of aging population trend, while 14% opted for the deficit funding of the pensions fund and low retirement savings. Apart from that, research on industry trust was conducted. It showed that almost half of the pension fund managers within the defined benefit program worries that they would have to reduce the pension benefit for the following 10 years, whereas around 70% believes the pension benefit would be fully paid in accordance with the promise. This deferred deficit needs to be addressed, moreover with the addition of these following challenges:

- Aging population in result of the decreasing birth rate and the increase of life expectancy.
- The declining trend of interest rate raises the question regarding the apt strategy of pension fund investments, this also cause the increase of liabilities that subsequentially dwindles the fund adequacy rate.
- COVID-19 pandemic impact.
- Significant rise of country's debt due to subsidy program which may affect country's ability to pay unfunded pension benefit and to provide social protection in the future.
- Inadequacy of pension's range and savings for employee, caused by either informal labor markets or the drastic increase of "gig employment" that leads to employee turnover from one employer to another.

2020 Mercer CFA Institute Global Pension Index

To show its commitment, in collaboration with Mercer and Monash Centre for Financial Studies, CFA Institute sponsored the 2020 Mercer CFA Institute Global Pension Index which was released in October 2020. Survey and rating of pension systems from 39 countries or around 2/3 of the world population were included in this 12th release of the report, based on the three sub-index which are adequacy, sustainability, and integrity. Following this, recommendations to improve each of the system were given.

It is difficult to establish this rating due to data limitation and assessment on implementation of existing rule. Therefore, this report relied on published data and information along with the existing rules, regardless of effectivity and discipline on its implementation. Nevertheless, this issue does not hinder the effort of delivering lesson, experience, or idea that could be helpful in developing and reforming the pension system.

It is mentioned in this publication that perfect pension system which could be implemented universally does not exist, however, there are several similar purposes that could be referred to achieve a better result, such are the following:

1. Adequacy aspect
    a. There is a minimum sum of pension benefit for poor that reflects the percentage that is reasonable to the average income of the community.
    b. Comparison between earnings in the pension period to the productive period for the median full-time employee is at least 70%.
    c. At least 60% from the total of pension fund cannot be taken all at once.
2. Sustainability aspect
    a. At least 80% of employee population become participants of voluntary pension fund.
    b. Present pension fund asset needs to be bigger than 100% of GDP to be able to fund for liabilities in the future.
    c. Work participation rate for population aged 55 to 64 needs to be at least 80%.
3. Integrity aspect
    a. There needs to be a strong and prudent regulator to surveil the pension fund.
    b. There is a periodic communication to participants in regard of personal provision statement, projected pension benefit, and an annual report.
    c. Clear funding regulation on pension fund both for defined benefit and defined contribution program.

It is also mentioned that to improve the adequacy and sustainability aspect of pension systems around the world, a global reformation is needed upon these following matters:

- Extend the scope of employee and self-employee participation within voluntary pension.
- Prolong the productive age.
- Promote employment participation rate to an older demographic population.
- Lessen the dependency to mandatory pension fund by encouraging employee to have greater personal savings.
- Reduce the rate of pension saving withdrawal prior to retirement age.
- Introduce a measure to narrow the gender gap.
- Improve the governance of pension fund and introduce a better transparency to increase participants' trust.

Ideal Retirement System

Various designs of pension system model have been proposed in several literatures, generally however, shortcomings in term of the most optimal practice guideline still exist. In the year 2015, CFA Institute collaborated with Mercer on publishing a report titled *Ideal Retirement System*. Composed from collection of pension design principles, it was developed based on the recommendation from CFA

Institutes' Future of Finance Council that was consisted of financial industry figures from around the globe. It is expected that this publication would become the basis of initial discourse for better model development.

Ten principles of **Ideal Retirement System** equipped with question checklist to help better diagnose and lessen the gap from those principles are as follows:

1. The government must establish clear objectives for the whole retirement system, including the complementary roles of each pillar, and incorporate the provision of a minimum income to alleviate poverty amongst the aged population.

• Which of the four pillars currently exist?

   a. Pillar 0, mandatory pension fund which provides minimum protection
   b. Pillar 1, mandatory pension fund linked to income during productive period
   c. Pillar 2, private pension fund that is mandatory and fully funded
   d. Pillar 3, private pension fund that is voluntary and fully funded
   e. Pillar 4, financial and non-financial support outside the pension system

• What is the participation rate for each pillar?

• Who is covered by the pillars (% of population)?

• Who should be managing the pillars?

• Can the pillars be effectively managed and operated?

• What is the funding level of the government sponsored retirement systems?

• What is the government appetite for reform/implementing the system?

• Are there incentives to save outside of the system?

• Are there opportunities for risk diversification in the universe of investable assets?

• Is savings for retirement mandatory or voluntary?

2. A minimum level of funding should be made into a pension system for all workers with contributions by employers, employees and the self-employed, as well as for those of working age who are receiving certain forms of income replacement. In effect, this means every worker will have a retirement account with an entitlement to future benefits.

• What is the number of people covered by retirement accounts?

• What is the number of people covered by DB plans?

• For DC plans, what is the average amount saved for retirement? What is the break-down by various metrics – socio economic?

• What percent of workers' plans are employercovered versus individual?

• What is the average percent of salary contributed?

• What is the average employer contribution?

• Is employee contribution higher when company offers matching funds?

• What is the average income of the worker?

• What is the average contribution per age group?

• What percent of pre-retirees are maxing out their contributions?

• What is the contribution level from disabled/parental/earned income (compared to regular contribution levels)

• What is the impact of cost reduction over time?

3. There should be cost-effective and attractive default arrangements, both before and after retirement, for individuals who do not wish to make decisions.

• Is there a default arrangement (DA) available?

• If DA is available, what type of arrangement is it?

• What is the cost effectiveness and participation rate of the DA?

• What type of default arrangements available? Contribution, Asset Allocation?

• Are there adequate investment choices for the DA?

• How many are choosing the DA?

• Should there be an opt-in for everyone to take advantage of the reluctance to change from the current status (opt-out)?

• What is the level of investment knowledge in the country or region?

• What is the average age of retirement – is it too high/too low?

• Is the DA fully funded or pay as you go (dependent upon contributions from future generations)?

4. The overall costs, including administration and investment, of each pension arrangement should be disclosed with some competition also present within the system to encourage fair pricing.

• How are the costs disclosed?

• How are the costs calculated? How is information communicated to participants?

• What is the individual and average fee arrangement?

• What is the number of providers/is the number sufficient? How flexible is it for participants to choose managers?

• Is there knowledge of the fee arrangements and impact of fees?

• What are the costs of trading and implementation of asset allocation shifts?

5. The retirement system must have some flexibility as individuals live in a range of personal and financial circumstances. This flexibility includes recognizing that retirement will occur at different ages and in different ways across the population.

• Is there ability to defer the retirement date?

• Are there early retirement penalties (for different age groups)?

• Are the contribution limits computed on a per year basis?

• Can participants contribute during disability and drawing disability pay?

• Is there the opportunity for remote work if commuting ability changes?

• Are there opportunities for part-time employment following retirement?

• How many people are working in retirement (what is average income)?

6. The benefits provided from the system during retirement should have an income focus but permit some capital payments or withdrawals during retirement, but without adversely affecting overall adequacy.

• Are there penalties for early withdrawal? What restrictions exists from early withdrawal?

• What percent of funds are being withdrawn early?

• What are the restrictions for the funds that are withdrawn early?

• How many borrow from account/how many are in default?

7. Contributions (or accrued benefits) at the required minimum level must have immediate vesting and portability. These accrued benefits should only be accessible under certain conditions, such as retirement, death or permanent disablement.

• What is the average vesting period?

• What benefits are lost due to turnover before vesting?

• What are the differences in vesting regimes?

8. The government should provide taxation support to the funded pension system in an equitable and sustainable way, thereby providing incentives for voluntary savings and compensating individuals for the lack of access to their pension savings.

• Is there flexible tax treatment for different accounts?

• Is the system pay as you go or funded by the beneficiary and/or employer?

• What is the total tax cost of the retirement plans?

• What percent of total system requires contributions from younger generations?

• What percent of contributions are dependent upon favorable tax treatment?

• Does tax treatment motivate savings?

9. The governance of pension plans should be independent from the government and any employer control.

• What are the fiduciary standards for governing pension plans?

• What is the current level of trust in the government controlled pension system?

• Are contributions considered tax or benefit?

• Is there a clear-cut fiduciary duty between plan and beneficiary?

• How do the pension plans communicate with beneficiaries (does it build trust and confidence)?

• What is the transparency level for the plans?

• What is the current insurance/guarantee level for pension plans?

• Are the plans required to be fully funded?

10. The pension system should be subject to appropriate regulation including prudential regulation of pension plans, communication requirements and some protection for pension scheme members.

• What is the current regulatory environment?

• Who is responsible for regulating each pillar and investments chosen?

• What are the number of complaints and amount of action/penalties?

• What is the main cause of regulatory action

In line with the editors' note, each country is located on different stages and is also faced with various history and population related cultural dynamism. These principles would sound familiar to some readers, while some others would find it controversial. This is in line with OECD 2019 report stated that the pension regime is very diverse dan often involve various programs. However, this publication is expected to stimulate healthy and productive debate in an effort of taking us closer to the solution of bringing benefit to the public.

Pension System in Indonesia

In this years' publication of *"2020 Mercer CFA Institute Global Pension Index"*, Indonesia is ranked number four in Asia and 30th out of the 39 surveyed countries, ranked higher than Japan, China, India, Mexico, Philippine, Turkey, Argentina, and Thailand. Indonesia is ranked on C category, on par with South Korea, Italy, and Spain. Although this placement means Indonesia has possessed several good features within its pension system, there still are some major risks and/or drawbacks that need to be addressed.

In this report, Indonesia scored 51,4 with the highest score for integrity sub index (68,7), followed by adequacy sub index (45,7) and sustainability sub index (45,6). This is lower compared to last years' 52,2, firstly due to the decrease of net replacement rate (comparison of net income during retirement to net income before retirement) which was published by OECD, then secondly the rise of longevity risk for pension system caused by the increase of life expectancy.

Prior to that, in the years 2018, 2017, 2016, and 2015, Indonesia scored 53.1, 49.9, 48.3, and 48.2 respectively. Historically, Indonesia has majorly improved their pension system through the regulation of *Social Insurance Administration Organization* starting from 2015, rising from the d level to the level C.

It is also mentioned in the report that pension system in Indonesia could be improved by these following measures

- Support on minimum income for the poor elderly.
- Extending the reach of pension membership for employee and self-employed to increase the level of saving and pension asset.
- Improve the regulation for voluntary pension system.
- Improve communication regulation to pension fund participant.
- Prolonging the productive age, considering the positive trend of life expectancy.

On top of that, inferred from various sources, several chances to improve Indonesia pension system can also be done with these following ways:

- Increase support and regulation transformation to encourage private pension contribution and by increasing the flexibility so that employees are not harmed by switching job.
- Reduce pension saving leak during productive age by limiting access to withdraw pension fund.
- Improve the governance and transparency to better increase the trust of public and participant.
- Intensify financial literacy programs so that individuals would be able to proactively make a financial planning including their pension plan, moreover with the trend of shifting from defined benefit pension program to defined contribution that doesn't grant investment result.
- Enlarge the financial institution pension fund market by also allowing asset management and securities company, not only life insurance and bank, to provide such a service
- The availability of annuity product which is reliable and competitive.
- Add more to the tax incentive to encourage public to increase their pension saving.
- Simplify enrolment process of financial institution pension fund through digital channels.
- Improve the effectiveness of risk management for voluntary employer defined benefit pension plan, where most of them are closed populations with declining trends of funding ratios and shortening investment horizons.

Realizing these issues, Indonesia government is putting high concern and commitment in pension issues by allocating a quite large state budget for social protection programs. Currently Ministry of Finance is leading the review process of Financial Sector Development and Strengthening Constitution including the pension cluster, by holding a series of focus group discussions among the parties where CFA Society Indonesia is also actively involved.

This is in line with William F. Sharpe's quote above stated that the challenges facing pension is multi-dimensional in nature (and spans across generations as well), where the commitment and collaboration from all related party is needed to improve adequacy, sustainability, as well as integrity aspect of pension system and its implementation. Especially for Indonesia this is the momentum to prevent the turning from our present demographic bonus into demographic curse, where the ratio of productive age population is lower than that of non-productive age, while those who are retired don't have the resources to support themselves in this increasing trend of life expectancy.

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