Voluntary Pension System

Speech of the Chairman, SECP, Dr. Tariq Hassan – 9 December 2005

Dr. Salman Shah, Distinguished guests, Ladies and Gentlemen, *Assalam-o-Alaikum*!

I welcome you all this morning to this Conference on Voluntary Pension System, a subject that the Securities and Exchange Commission of Pakistan is pleased to introduce in Pakistan. I want to thank you for coming here today; many of you have travelled great distances to share your knowledge. It will be your contribution and the exchange of information and sharing of best practices that will make this event a success.

For us this Conference is timely. In a story called **New Thinking on Old Age,** in the Economist of 30th November 2005, it is stated that, "Across the rich world, governments are searching for ways to ensure that their citizens are taken care of in their old age. Can lawmakers fix their pension problems before it is too late?" We feel that problems of the rich world will have to be addressed sooner or later by developing countries such as ours. We prefer to be pro-active as the implications of addressing this matter late will be tremendous and even costly to resource strapped countries like ours.

Ladies and Gentlemen:

In Pakistan, the current tools for retirement savings are not many in number and the few available are under-utilised. A large reason for this is that majority of the people in the country are not salaried employees, but are self-employed. The concept of a regular income is alien to them. Additionally, the emphasis of the society on joint family system allows people to live with their children in their old age even if they don't have retirement savings. I fear that as modern medicine advances and mortality is improved, this system will become increasingly taxing on the newer generations, and on a stand-alone basis, might not be feasible a few years from now!

Our society is already experiencing a gradual cultural change, driven by economic limitations, which is doing away with the concept of family dependence. In the absence of a proper social safety net in the country, this will become a significant socio-economic challenge for all of us. Introduction of a structured & robust pension system is therefore very timely to equip our society to deal with such future challenges.

Pensions affect society in two ways. Firstly, they provide the retired segment of the society with income to support them. Additionally, pensions promote long-term savings by the younger, economically active strata of the society. Thus, they not only have a social impact on the society, but also an economic impact.

Since the public sector is a large employer in Pakistan, majority of the pensions given here are by the government to their employees and these, along with the very limited number of *private* pension schemes, are mostly defined-benefit in nature. The defined-benefit system not only creates a liability for the provider, but also *reduces* the incentive to save more than what is required by the scheme. Additionally, the employees miss out on the savings if they leave or switch too early. The predominant forms of *private* occupational savings schemes in the country are Gratuity Funds and Provident Funds, whereby the money can be used by the participants as they switch jobs, instead of at retirement. These, therefore, can hardly be called pension schemes.

Employers are better at investing. But pensions require them to make promises that come due half a century later—when market conditions may have changed radically. Employers are often tempted to overestimate the returns they will get on their pension-fund investments and shrug off the liability in bankruptcy if things go wrong. Moreover, having your retirement dependent on the same firm that provides your pay cheque puts all your financial eggs in one basket—a violation of basic investment principles. This is what is now devastating America's carmakers and big airlines to name a few examples, and why companies in Britain and America are quickly switching their workers out of defined-benefit pensions into voluntary savings schemes.

Ladies and Gentlemen:

The Voluntary Pension System is a voluntary, defined contribution system where anyone in Pakistan over the age of 18 with a valid National Tax Number can choose to create an account with any of the approved pension fund managers and may contribute up to 20% of his or her net taxable income. The participants get to choose the amount of their contribution as well as how aggressive or conservative their contributions are invested. These contributions, as well as the gains from investing them, will be tax-free; while under the current structure, tax shall be levied at the time of withdrawal of money. Thus, while tax incentives encourage people to participate, and tax penalties on early withdrawals promote long-term savings, participants *still* get a lot of control over the income that they will ultimately receive after retirement.

The Voluntary Pension System has one considerable advantage over the defined-benefit system - **portability**! People not only have power over how much to invest in their pensions, and how to invest it, but their savings stay with them even if they change jobs.

Ladies and Gentlemen:

Given the long-term nature of the scheme, where people will regularly pay their contributions for up to 40 years, continuous vigilant regulation will be needed. This will be unlike anything we have seen and we plan to rise to the challenge to refocus on the long term perspective a voluntary pension system envisages.

SECP started working on this System in 2003, soon after we got the mandate to regulate and promote private pensions in the country. SECP has already formed a Pensions Wing dedicated to implementing the Voluntary Pension System and exploring other areas where it can have a constructive role to play. So far, the Pensions Wing has been actively formulating rules and guidelines, with constant feedback from the market, for implementing the Voluntary Pension System in the country. These rules and guidelines shall be practical but strict, and will be effectively enforced. Applications for Pension Fund Managers will be thoroughly scrutinized and assessed before allowing them to manage such funds. These Pension Fund Managers will be carefully selected based on past performance and current management and practices.

For long-term success of the VPS, it is imperative that it be allowed to compete with existing schemes on level ground. This will require certain changes in the current tax structure, which we are working on and hope to send our recommendations to CBR in the near future.

Recently, two major conferences were held in Karachi and Lahore, where suggestions were invited from the industry regarding VPS. Additionally, an Advisory Committee has been set up consisting members of the public as well as the private sector. Feedback from the

Advisory Committee meetings as well as the conferences has been effectively incorporated into the rules and guidelines governing VPS.

With the successful launch of VPS, the next step is to effectively monitor it, with proper collection of data. In the coming years, SECP will seek to consolidate all the pension schemes, for effective monitoring and regulation, as well as data collection and analysis that would be helpful in formulating future policies. To that end, we hope to liaise closely with CBR, which recognizes provident funds, gratuity funds, and other pension schemes, to collect the information required to build a comprehensive database of relevant statistical information.

We hope to, eventually, allow pension fund managers to invest in foreign markets, as well as in real estate. Real estate especially, is a market untapped by professional asset managers owing to lack of documentation and formal price-discovery mechanism. Removing of such hurdles can lead to the introduction of Real Estate Investment Trusts and other modes of investment into real estate, which provides a great way to diversify the risk while providing desirable returns.

With taxation benefits, as well as introduction of further long-term investment opportunities, it is hoped that VPS will become the foremost vehicle for providing post-retirement income in Pakistan and will, *Insha Allah*, help its contributors in maintaining their living standards after retirement.

I have said this at a prior occasion and I say it again now: It is particularly important to focus public education on the need for self-financing of old age income. It is not only the SECP and the fund managers who need to spread the word, but social organizations, parents and teachers need to educate the younger generation, so that this concept is engrained in the society as it ages.

Finally, an initiative of this magnitude does not happen in isolation. It was the vision of the then Finance Minister and current Prime Minister; Mr Shaukat Aziz who felt the need for such a system because there are hardly any private pension schemes in Pakistan. We owe a lot to his continued support.

I would also like to thank the Finance Division of the Government of Pakistan for their valuable support of this project. Provisions have been made for broadening of the investment base for the VPS in the future and this will not be possible without their continuing support. In particular, *Chaudhary Anwar*, deserves special mention.

As far as tax related matters go, I gratefully acknowledge the support of the Central Board of Revenue. The 2005 finance bill allowed for the amendments to the Income Tax Ordinance 2001 necessary for launching the new System. The CBR have been active participants at the conferences I just mentioned as well as in the advisory committee meetings. They are well aware of the feedback received and we are moving together towards incorporating that into the next finance bill.

The World Bank has been instrumental in assisting in financial sectors reforms in Pakistan. I'd like to acknowledge the contribution of Richard Heinz, from the Social Protection Unit in Washington DC, and *Abid Hasan* from the World Bank office in Islamabad.

Last but not the least, I must also acknowledge the contribution and commitment of SECP colleagues who have been a driving force, in particular Mr. Etrat Rizvi, former Commissioner; Salman Ali Sheikh, Commissioner; Shafaat Ahmed, Executive Director; and Akif Saeed, Director Pensions.

I hope participants will benefit from today’s proceedings and spread the word in order to help SECP in informing and educating the public for whose benefit this system has been devised.

Thank you!