

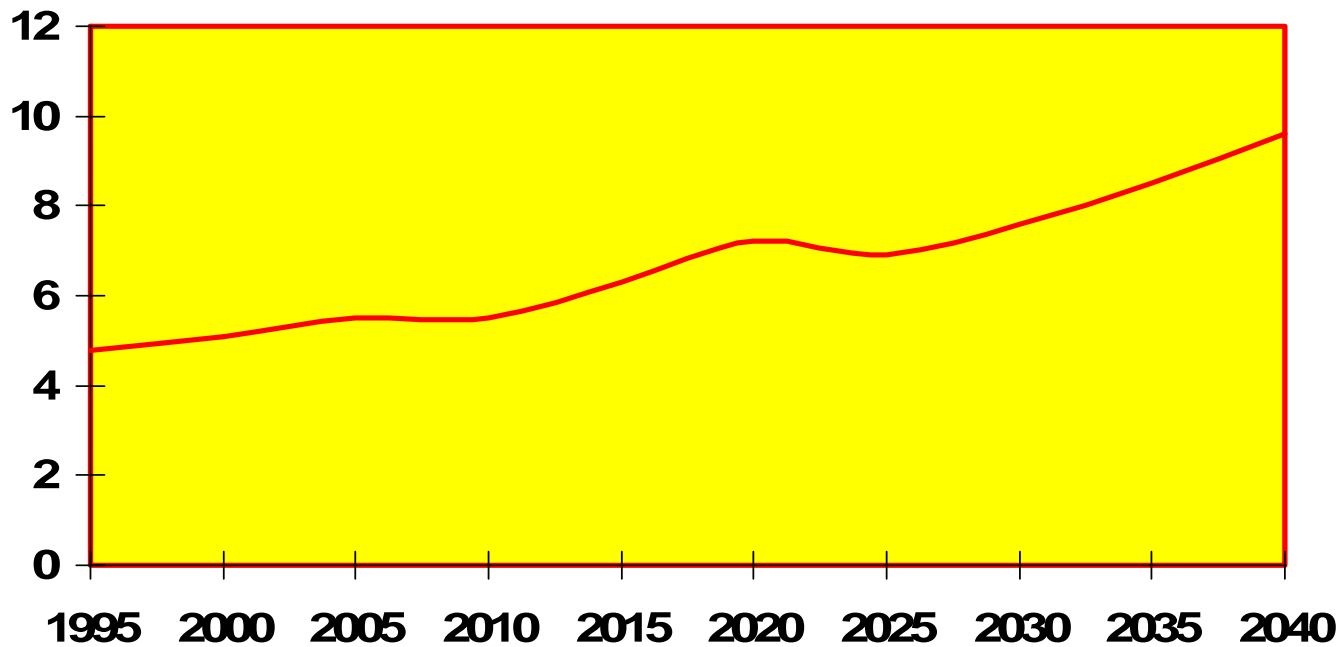
# Private Sector Retirement Arrangements in Pakistan

15 April 2006

# Retirement Benefit Schemes – Role

- The basic purpose of retirement benefit schemes is to provide financial resources after retirement
  - The prime role is, therefore, social
  - The provision of retirement benefits is, therefore, often a part of social security legislation
- Historically, the social security “system” in the country has been largely family based, with children supporting parents after retirement.
- Is this system sustainable in the long run ?

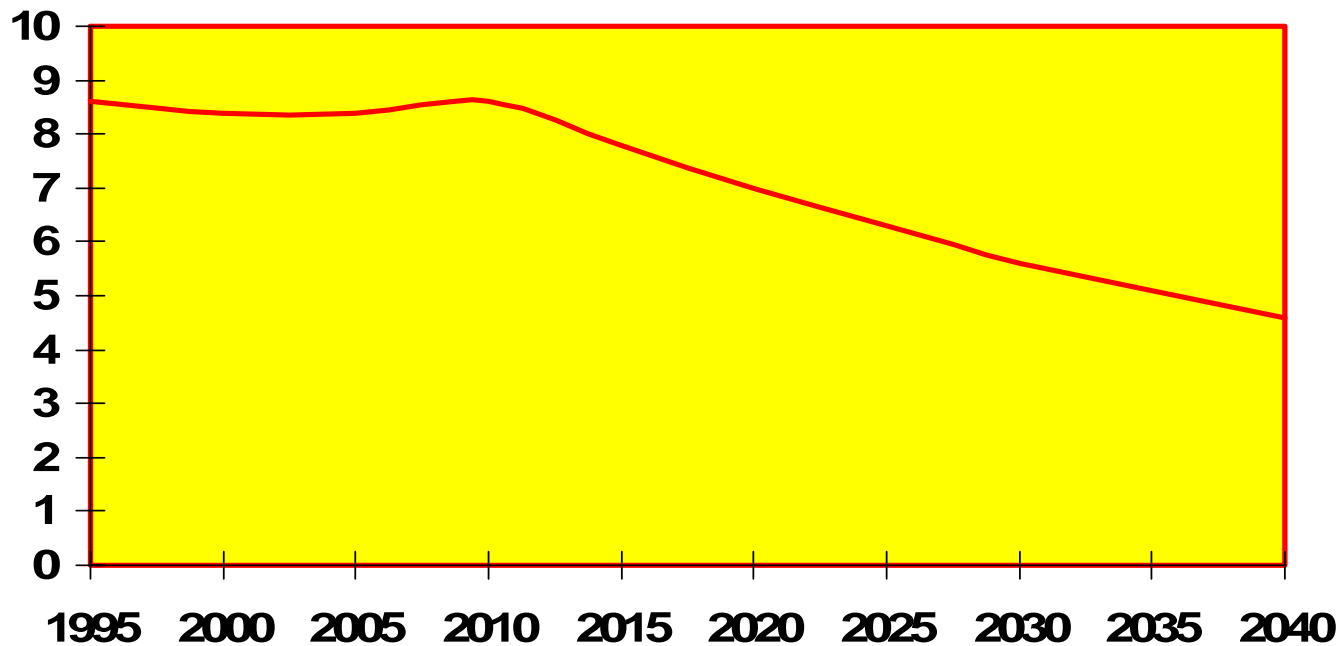
# Pakistan – Ageing Estimates



*Percentage of Population over Age 60*

World Bank Paper (dated April 2000) on International Patterns of Pension Provision

# Pakistan – Ageing Estimates



*No. of Persons Aged 20-59 / No. over Age 60*

World Bank Paper (dated April 2000) on International Patterns of Pension Provision

# Retirement Benefit Schemes – Role

- There is, therefore, a need to look at alternative methods of providing for the elderly.
- In developed countries, and increasingly across the world, the main vehicle is through old age pension systems.
- In Pakistan there is some coverage through retirement benefit schemes, although these have concentrated on lump sums (provident funds and gratuity schemes)
  - The utility of lump sum benefit systems, is limited, as this passes on the responsibility of managing funds, and the risks of longevity to the retiree.
  - Pension schemes exist, but very predominantly in the public sector (including government) and multinationals.

# Where Does Pakistan Stand ?

Country	Covered Wage Bill/GDP	Contributors/ Labour Force	Contributors/ Working Age Pop.
Pakistan	0.6%	3.5%	2.1%
India	3.2%	10.6%	7.9%
Malaysia	17.4%	48.7%	37.8%
UK		89.7%	84.5%

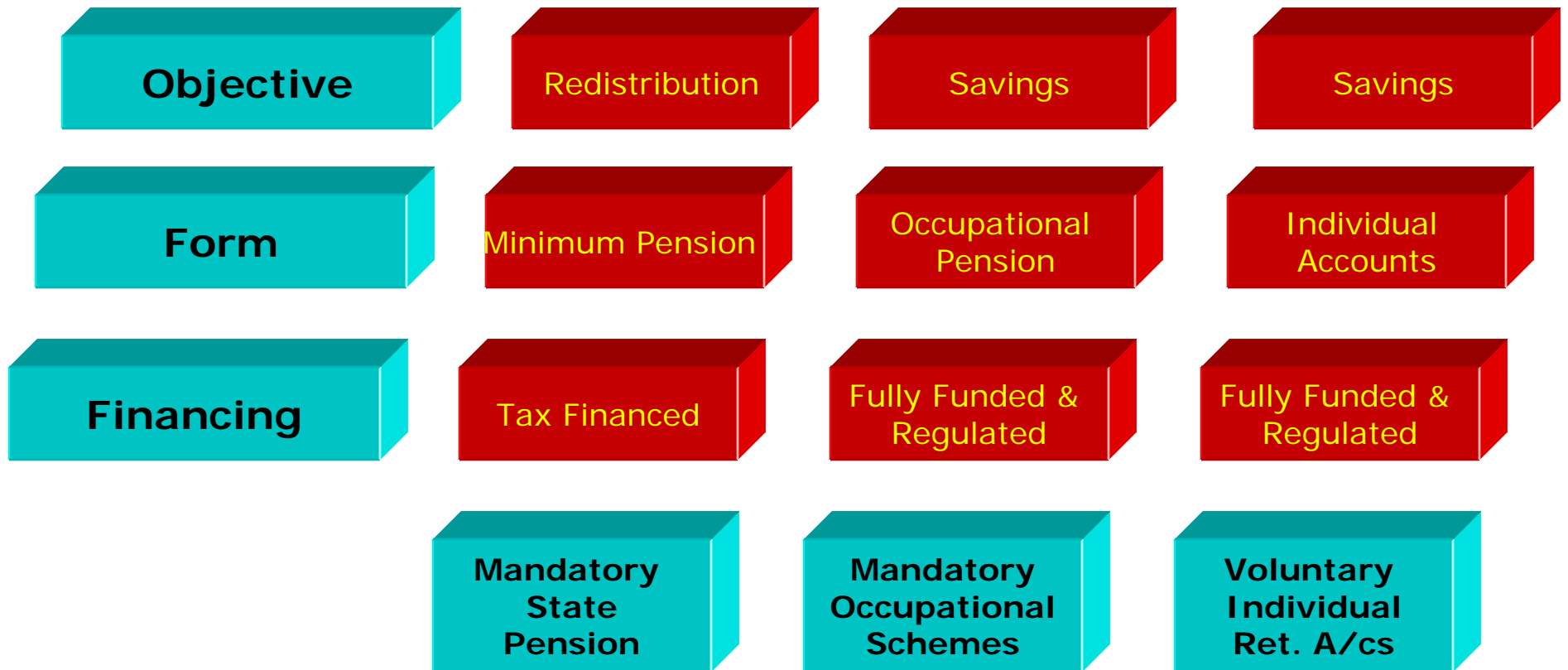
# Retirement Schemes – Other Benefits

- Important benefit from an employee perspective
  - Encourages retention of employees
- Promotes savings
  - Funded pension schemes are an important part of contractual savings
  - Potentially significant effect on capital markets

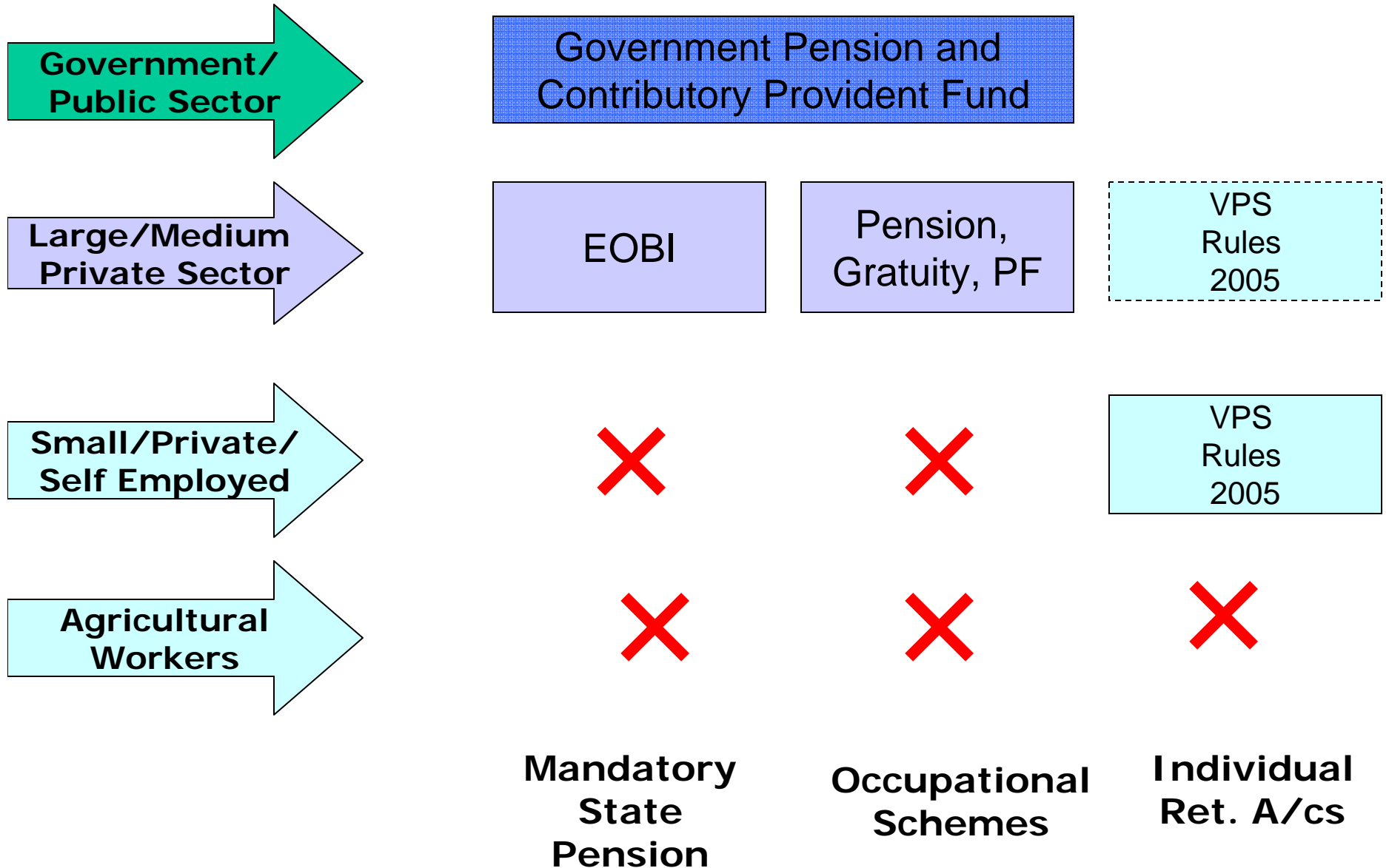
# Pension Regimes – Standard Models

- Various models for providing pensions exist throughout the world, ranging from full responsibility resting with the state (in socialist economies) to economies where very little is done by the state, with the exception of public servants
- Systems are, however, becoming increasingly standardized, not least because of the intervention of international lending agencies, who are promoting a standard model for pension schemes, based on a “multi-pillar concept”
  - There is a proposed Asian Development Bank initiative for Pakistan
  - Therefore a need for the country to do it’s own thinking in order to avoid implementation of a “standard” model without thinking

# The World Bank 3 Pillar Model



# Fitting the Standard Model to Pakistan



# Scope of Presentation

- Government Retirement Benefits being separately covered by Finance Division
  - Caveat – may not be looking at all levels of government
    - especially city and district governments and autonomous bodies
- The EOBI scheme has been covered by Mr. Akhtar Jamil Khan
- VPS has been covered by Mr. Atif Saeed
- This presentation therefore covers existing arrangements for retirement benefits in the private sector Occupational Schemes
  - Some comments at the end, however on suggestions in all schemes

# Prevalent Retirement Benefit Schemes

- Three schemes prevalent
  - Provident Fund
  - Gratuity
  - Pensions
- Under the Labour Law (West Pakistan Industrial and Commercial Establishments Act 1968) provision of gratuity (30 days' basic salary) is a must for employers with 50 or more “workers” unless they have a provident fund scheme (no minimum benefit level mentioned)
  - No protection for non-workers
  - No protection where number of workers is less than 50

# Provident Fund

- Defined contribution scheme
  - Contribution as % of salary (5 to 10%) by employee and matching contribution by employer
  - Accumulated in individual accounts
  - Investment income credited based on balance
  - Investment subject to SECP regulation (no tax on investment income)
- Lump sum paid on leaving employment (even if the employee takes up employment with another employer)
- Permanent withdrawals allowed during service for particular purposes
- Loans against PF balances allowed
- Employer contribution allowed as tax deductible expense (up to 8.33% of salary) provided scheme approved by Income Tax Department

# Gratuity

- Defined benefit scheme
  - Lump sum payable on leaving service (through retirement or otherwise) based on salary (normally final salary) and period of service
- Scheme normally unfunded although sometimes funded.
  - Contribution to fund allowed as tax deductible expenditure provided fund approved under Income Tax Rules
- Taxable status of benefit dependent on whether scheme
  - Unapproved
  - Approved but unfunded
  - Approved Gratuity Fund

# Pension

- Normally defined benefit with pension determined based on salary (normally final or final average) and period of service
  - Pension normally payable from retirement age – lower amount payable on early retirement other than due to disability
  - Provisions for early benefit on death or invalidity
  - Commutation of up to 50% of the pension at retirement allowed
- Some defined contribution scheme with coverage for death and invalidity
- Normally funded
  - Contributions allowed as deduction for tax up to 20% provided scheme is approved as Approved Superannuation Fund under Income Tax Rules

# Schemes – Funded/Legal Status

- Provident Fund schemes funded by their very nature
- Gratuity schemes tend to be unfunded
  - Affects the taxability of the benefit
- Pension schemes tend to be funded, although unfunded schemes also exist
- Funds generally established under the Trust Act 1882

# Some Indicative Statistics

- SHMA carried out a survey in 2001 which indicated the following proportions in terms of popularity of schemes

<b>Combination</b>	<b>Prevalence</b>
Provident Fund only	12%
Gratuity Only	6%
Pension Only	6%
Provident Fund + Gratuity	61%
Provident Fund + Pension	6%
Pension + Gratuity	0%
All three plans	8%
No plan	1%

- Proportion of Gratuity probably understated as the unorganized sector generally offers gratuity as a benefit

# Legislative Framework

- Taxability of benefits and extent to which contributions allowed as deduction in computing taxable income is governed by Tax Laws (Income Tax Ordinance 2001 and Rules 2002)
- Company law (S227 of Companies Ordinance) provides for regulation of provident fund – SECP being the regulator
  - However, very little in terms of regulatory provisions for pensions and gratuity schemes
    - Investment of funds follow the Provident Fund regulations
- SECP is apparently responsible for “Pensions” Regulation
  - Practical impact of regulation yet, however, to be felt
- There is an ADB financed consulting project (administered by the Ministry of Finance under TA Loan 1956-PAK) directed at establishment of an overall framework for pension provision in Pakistan (pension to be read as retirement benefits)

# Enhancements to Regulations

- Social security legislation required to enhance coverage
  - Especially to include the informal sector including agricultural workers
  - Further discussion on this aspect beyond the scope of presentation
- “Pension” (read as Retirement Benefit) legislation required to regulate benefit promises which are made and to align benefit design with objectives.

# Objectives of Pension Regulation

- Ensuring the adequacy of schemes (i.e., that the benefit design is appropriate for meeting the primary social objective – the provision of an income after retirement)
- Ensuring that promises made to prospective pensioners by pension schemes are met. This involves the following:
  - Requiring separation of the scheme assets (the fund) from the sponsors (the employer)
  - Ensuring the inherent viability of pension schemes, usually achieved by requiring an actuarial investigation to be carried out.
  - Regulation of investments made by funded schemes to ensure prudence and matching of assets and liabilities
- Ensuring that promises made are reasonable. This would mainly apply to insurance and asset management companies operating pension schemes.
- Ensuring that pension liabilities are correctly accounted for. This has largely been met by IAS19 and IAS 26.
- Ensuring equity between different classes of pensioners/ prospective pensioners. This has two dimensions:
  - the treatment for tax purposes of contributions towards pension schemes;
  - sharing of costs of pensions between different generation of pensioners, this being a major issue with respect to government pension schemes and the EOBI.
- Encouraging or discouraging various forms of pension arrangements in line with government policy
- Making pension arrangements and related tax benefits more accessible.

# Adequacy of Benefit Design

- Objective of retirement savings not being met
  - In both gratuity and provident fund schemes benefit paid on change of employment – not necessarily retirement
  - Even at retirement benefit paid as a lump sum. Even in pensions 50% is commuted – hence responsibility for investment of the lump sum rests with the retired person.
- SECP is aware of this issue – hence restrictions placed on initial design of VPS.
- Gratuity and PF Schemes do not provide for adequate levels of benefits on death or invalidity at a young age
  - Although some schemes insured in order to provide a base level benefit
- SECP needs to prescribe certain design parameters by which all retirement benefit schemes must adhere. This may distinguish between types of schemes (eg., defined benefit occupational schemes and individual retirement accounts may have different parameters).
  - Tax benefits need to be linked to adherence to these parameters

# Protection of Scheme Assets

- Funding is currently not mandatory (other than for PF schemes). Also where funds exist there is nothing done to ensure that a minimum level of funding is achieved (maintenance of a Minimum Funding Rate).
- Where trust funds are created trustees tend to be under control of the employer
  - Dilutes the protection
- Actuarial valuations are not mandatory other than for listed companies to comply with IAS-19. IAS-19 focuses on recognition/disclosure in employer entity accounts rather than on funded status of scheme.
- IAS-26 apparently in force for listed companies. Also regular audit mandated. However not strictly followed up.
- Suggest that:
  - Funding be made mandatory with minimum funding rates being prescribed (100% for Provident Funds) – periodic actuarial valuations should be a must for defined benefit schemes.
  - Strict implementation of financial reporting and auditing regulations. Also make these applicable for all schemes – not just for those related to listed companies.
  - Rules should require some trustees to be independent of sponsoring employer entity

# Investment Regulations

	<b>Investment Instrument</b>	<b>Maximum % of Fund that can be Invested</b>
1	Government Securities	100%
2	Scheduled Bank Schemes	100%
3	WAPDA Schemes	100%
4	Listed Securities (including TFC's; closed end mutual funds)	30%
5	Unit Trusts	50%
6	Index Funds	10%

- Regulations also prescribe rules for the individual listed security and maximum limits for investment in a single entity (by capital).
- Regulations broadly appropriate. However needs more attention (eg., limiting overall investment in equities and unit trusts together (currently 80%), restricting investment in employer entity, allowing investment in property, etc).
- Pension Funds can invest in a life insurance policy (usually a deposit administration or deferred annuity contract). No such provision for gratuity schemes however.

# Greater Accessibility to Funding

- Schemes tend to be single employer (although some multi-entity schemes exist within groups)
- Funding requires tax approval, setting up a trust and maintenance of the trust. The effort involved discourages following this route.
- Suggest that third party institutions be allowed to set up multi-employer funds to which contributions may be made by employers which may qualify as tax deductible
  - Similar to the current provisions to invest in life policies by Approved Superannuation Funds but without the need to go through the Trust Route
  - Such schemes can be managed by Life Insurance companies or asset management companies and be subject to prior approval by the SECP (similar to the VPS)

# SECP VPS Rules 2005

- Allows the setting up of Individual Retirement Accounts within funds set up by Life Insurers and Asset Management Companies
- Rules in place for maximum level of charges
  - May actually discourage sales of this product, especially by life insurance companies geared to high levels of commission for sales of individual life insurance policies
- Rules in place to ensure that early withdrawal of savings discouraged.
- First scheme yet to be introduced under the rules, although it is believed that multiple applications from life insurers and asset management companies have been received by the SECP.
- Capital contribution issue in the case of life insurers

# Insurance and Pensions

- Life insurance companies have, in many countries, been providers of pensions
  - Group Schemes
    - Deferred Annuities
    - Deposit Administration
    - Managed Funds
    - Immediate annuities
  - Individual Schemes
    - Deferred Annuities
    - Individual “Savings” schemes geared to producing a lump sum at retirement which can then be converted to an annuity
- VPS includes life insurance companies registered under the Insurance Ordinance 2000 as one of the categories of institutions eligible to register as pension fund providers

# Insurance and Pensions – What is Required

- Occupational schemes currently have to form trust funds in order to qualify for tax relief on contributions
- This could be done away with if an arrangement such as the VPS is extended to occupational defined benefit schemes administered on a group basis
  - Will allow employer entities easier access to tax benefits and therefore encourage funding of retirement arrangements
  - Will probably ensure that the funds are invested more professionally
- Suggest that the SECP take this on as the next target
  - Include both insurers and asset management companies

# Conclusion/Recap

- Government/SECP need to focus on
  - Expanding coverage by introducing social security legislation to cover the informal sector including agricultural workers
  - Introduce legislation to regulate occupational schemes already in existence
  - Introduce third party arrangements to ease the setting up of schemes by smaller employers
- Government also needs to seriously focus on increasing the institutional capacity of EOBI in order to allow it to eventually expand its scope of coverage