



Voluntary Pension System Rules and Life Insurance Companies

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VPS Objectives

- Started off as a vehicle to provide pension to individuals who did not have access to any form of retirement savings plan
- Now any individual tax payer can join and claim tax credit subject to contribution limits
- Individuals are also allowed to transfer their provident fund and pension fund balances to VPS
- Is the objective to generate new savings or cannibalize existing savings?
- Is the objective to bring in new individuals to the pensions net?

What makes VPS unique?

- VPS is a tax qualified savings vehicle. In essence it is the tax treatment which makes it unique
- In return for preferential tax treatment, VPS managers and products need to meet certain requirements
- Most important of these requirements is the limit on charges
- The old Section 63 provided tax credit on certain pension products issued by life insurance companies with withdrawal restrictions.
- This section was deleted leaving existing policyholders in a vacuum
- If the intention was to regulate charges and withdrawals, this could have been easily achieved by amending Section 63

Role for Life Insurers

- Afterthought?
- VPS Rules promulgated under provisions of the Companies Ordinance 1984 which apply specifically to non-banking finance companies
- SECP is now of the view that since the enabling provisions of the VPRS apply only to NBFCs, life insurance companies cannot act as pension fund managers despite provisions in the VPRS rules (Rule 4 Eligibility for registration).
- VPS Rules drafted in a mutual fund context
- Rules completely ignore the special nature of life insurance business and provisions of Insurance Ordinance 2000
- Can a voluntary pension system function without an effective role played by the life insurance industry
- Presently, only one life company has applied for registration as pension fund manager
- The enabling provision issue of VPS Rules should be resolved before any licenses are given so that mutual funds do not have the first movers advantage

Financial Issues

- Under S 14(4) of IO 2000, a life insurer has to maintain a separate Statutory Fund for pensions business.
- Under S16 a policy is referable to one or more statutory funds. This means that all VPS contracts issued by a life company will have to refer to its Pensions Statutory Fund.
- Under VPS, contributions have to be made in favor of the trustee – Is this possible in the case of a life insurance company. Under IO 2000 S17(2) all amounts received by a life insurer in respect of the business of a statutory fund are to be credited to that fund
- Under the VPS Rules the life company will need to set up funds as separate trust funds for the investment of the VPS contracts. As these will be separate legal entities it is not clear how contributions paid into the fund and withdrawals from the funds will be treated.
- Then there is the seed capital issue. If the seed capital is contributed to the statutory fund by means of a capital transfer, then it gets treated as negative equity.

Financial Issues - One Approach

- The Pension Fund is set up outside the books of the life company as a trust fund.
- There is an investment from the Shareholders' Fund to the Pension Unit Fund in the form of an investment to acquire units in the Unit Fund. The units held are treated as an asset of the Shareholders' Fund.
- Contributions are invested net of charges in the unit fund. Charges made to the contracts are treated as revenue income, with risk claims and expenses being treated as outgo from the statutory fund. The assets and related unit liability are considered external to the statutory fund.
- To the extent that the unit fund has any inflows from contracts part of the seed capital may be taken out of the unit fund by redeeming units.
- Even with this approach there may be a strain in terms of the solvency margin required in the shareholders fund as part of the seed capital units may be considered inadmissible

Marketing

- Cap on front end fee (3%) and investment management charge (1.5%)
- The charge structure does not provide margins to offer high first year commission needed to promote sales of the product through a life insurance sales force
- A high first year front load followed by lower renewal loads would have been a better option
- For example a regular contribution of Rs 100,000 per annum accumulated at 8% per annum (net of investment management charge) results in a fund value at the end of 30 years of Rs 11,867,549. The same scenario if repeated with a first year charge of 10% and renewal charge of 2.5% results in a value of Rs 11,853,252
- Life insurance companies can play an important role in the development of the VPS market due to their expertise and competitive advantage in the distribution area
- Market conduct rules
- Illustration regulations

Operations

- Premium collection: if annual then sales person plays an important role, if monthly then can work through payroll deduction or direct debit. In all cases the administration system needs to be capable to issue notices and coordinate with the relevant parties on a regular basis.
- Persistency: Life companies know the importance and use numerous tools to ensure good persistency of business. The inability of the participant to save regularly in a disciplined manner will foil his VPS plan objectives. Life insurance companies can help in this process by making use of their tools and systems to ensure good persistency.
- Life insurance companies invest heavily in a good administrative system. Use of the same systems for VPS can result in cost efficiencies which can ultimately be passed on to the VPS participants.
- The role of the Appointed Actuary

The Way Forward

- It is clear that the life insurance industry has certain competitive advantages which make them ideal institutions to promote VPS business
- The life insurance industry has to play an important role in VPS business and needs to be involved
- The Insurance Ordinance 2000 provides a robust framework under which VPS could be conducted by life insurance companies
- A solution could be promulgation of an alternative set of VPS rules under the Insurance Ordinance 2000. Section 167(1) allows the Federal Government and Section 167(3) allows SECP to make rules/regulations to carry out the purposes of the Ordinance. The same provision was used to issue Takaful Rules 2005. This should be possible as the Insurance Ordinance 2000 recognizes pension fund business as a class of life insurance business.