The Voluntary Pensions System

An Overview

Nasim Beg

9 December 2005

Retirement Incomes in Pakistan At Present

- Most of the working population employed either in public/private; entrepreneurial occupation relatively low
- Government ensures well-being of its employees via DB schemes (unfunded pension), provident fund
- Provident funds & unfunded gratuities the norm in private sector – no portability
- Bulk of rural populace (65% of country's population) & low-income groups totally reliant on family support after retirement

Need for the VPS

- Urgent need to ensure adequate savings and retirement income provision, especially for rural and low-income populace
- Traditional avenues for investment such as bank deposits and the NSS have shifted to market-driven returns; have lost appeal as a source of long-term savings
- Little or NO equity market investment with a view to provide retirement income
- Long-term savings finding a home in capital markets likely to bring benefits of economic growth to the citizens

Need for the VPS - (contd.)

- At corporate level, urgent need to shift from defined benefit to defined contribution
- Even in developed, sophisticated financial markets, impact of retirement benefits has caused/threatened bankruptcies – Enron, General Motors, United, Delta, Northwest Airlines
- Cost of guarantee has to borne somewhere within the system – usually the taxpayer
- DC provides the same or greater level of benefits as DB over long run, while maintaining flexibility

The VPS - Structure

- EET (exempt-exempt-tax) structure
- Similar to the 401(k) and the stake-holder pensions system; individual savings accounts
- Range of retirement ages between 60 and 70 years
- Vehicle for personal savings, and hopefully corporate retirement benefits provision too
- Introduced vide Finance Division notification; regulated by the SECP
- Overview can be segregated into Contribution, Investments, Taxation, Benefit Disbursement

The VPS – Fund Managers

- VPS business can be entered into by life insurance companies and asset management companies
- Remunerated by front-end sales load of maximum 3.00%; investment management fee of 1.50% per annum
- Seed capital requirement of Rs. 50 million for each sub-fund, to be maintained for a minimum period of 3 years
- Strict regulation and over-seeing by the SECP

The VPS - Contributions

- Contributions allowed by individuals as well as employers on behalf of their employees
- All Pakistani citizens older than 18 years of age and who are registered tax-payers eligible to contribute; must not be member of occupational pension scheme
- Flexible contribution by individual, subject to limit of 20% of taxable income for year, with 2% catch-up per year of age exceeding 40 years; maximum of 50% of taxable income in all cases
- Maximum contribution allowed in all cases during any financial year is Rs.500,000 (employer + employee)

The VPS – Contributions (contd.)

- Companies can contribute to their employees' VPS account balances so as to provide benefit equivalent to their current benefit structure
- Employer should project investment growth, salary growth
- Basis of equality can be annuity basis for pension schemes, or actuarial present value in case of lump-sum benefits
- Try to attain similar levels of income replacement upon termination under VPS and pension/gratuity schemes

The VPS – Contributions & Taxation

- Income Tax Ordinance amended to provide tax-breaks on contributions to the VPS by individuals

- Corporate contribution tax-neutral between VPS and other retirement benefits

- Tax credit computed with reference to proportion of salary contributed to VPS account, and individual's tax liability before taking contribution into account

The VPS –Taxation

- Tax credit computed as follows :

(A / B) x C where

A : amount of tax assessed to the person for the tax year, before allowance of any tax credit;

B : Person's taxable income for the year

C : lesser of (i) Total contribution paid into the VPS

(ii) 20% of person's taxable income for the year, increasing by 2% for each year of age exceeding 40; maximum of 50%

(iii) Rs. 500,000

The VPS –Taxation (contd.)

- Amount of tax credit increases with amount of contribution : encourages savings rates to increases
- Since tax credit is levied on a proportionate basis, as income grows not only will absolute amount of savings grow, but the proportionate tax savings will also increase
- Increases tax credit with age; consistent with natural tendency to become more prudent with age
- Limit of Rs. 500,000 should be reviewed with time so as to remain meaningful in face of inflation

The VPS – Investments

- At present, investment allowed in equity, debt, money markets via sub-funds
- Real estate, other asset classes after 5 years of successfully managing above 3 asset class funds
- Equity sub-fund must remain at least 90% invested in listed shares; per share exposure maximum of 5% of NAV
- Aggregate investment in green-field ventures allowed up to a maximum of 5% of NAV, per company exposure max of 1% of NAV
- Per sector exposure maximum of 20% of NAV

The VPS – Investments (contd.)

- Debt sub-fund allowed to have maximum weighted-average duration of 10 years;
- Pension fund managers should seek to run fund at significantly lower duration; 10 years will allow too much volatility
- At least 50% of debt sub-fund required to be invested in federal government securities
- Remainder in debt securities issued by provincial governments, corporate entities
- Per-security exposure depending on credit rating of issuer; per issue limit of 5% and 2.5% in case of 'A-' or 'BBB'

The VPS – Investments (contd.)

- Most corporate issues come with floaters – highly desirable since protect against inflation and also low duration
- Very low float of TFC's; low number of issuers, very low market activity; therefore bulk of debt sub-fund likely to be invested in federal government securities like PIB's
- PIB's not auctioned very often (last issue was 1.5 years ago)
- Carry fixed coupons – interest rate risk
- Prudent exposure limits – should not alter those to fit current market conditions
- Allow term deposits as acceptable asset class for debt fund; explore possibility of bringing out government bonds with floating coupons

The VPS – Investments (contd.)

- Money market sub-fund not to carry duration of more than 1 year

- No limit on amount of federal government securities and bank deposits

- 20% limit on securities issued by provincial government, quasi-governmental corporations or corporate entities

The VPS – Individualised Asset Allocation

- Individual account balances will be invested in combination of equity, debt and money market sub-funds to provide mix of risk/return available in each asset class as seen appropriate

- Asset allocation biggest determinant of terminal benefit; should be chosen keeping in mind the risk profile of the scheme participant

- For VPS-style schemes, investment allocation should reflect age, time to retirement : **life-cycle investment plans**

The VPS – Individualised Asset Allocation

- Typically life-cycle investment plans involve higher exposure to equity at earlier ages, dropping off to near-zero as retirement approaches
- Other asset allocations mandated by SECP are:

	Debt	**Equity**	**Money Market**
Aggressive	Min 20%	Min 65%	Nil
Balanced	Min 40%	Min 35%	Min 10%
Conservative	Min 60%	Min 10%	Min 15%
Very Conservative	Min 40%	Nil	Min 40%

The VPS – Individualised Asset Allocation

- Daily NAV's of each sub-fund managed by all pension fund managers
- Six-monthly review by SECP of investment performance
- Investment rules silent on topic of investment of funds in draw-down phase; need to safeguard funds once retirement is reached and income draw-down starts AND protect against inflation
- One approach to ensure capital protection would be to invest 100% in money market sub-fund to protect pensions-in-payment; Other combinations also possible/desirable, depending on preferences
- Could also introduce a fund composed of 100% floater bonds : HIGHLY DESIRABLE, MAYBE NOT POSSIBLE

The VPS – Benefit Payouts

- Benefit payout in case of :
  - Early retirement
  - partial or total withdrawal of account balance before retirement age
  - Death/disability/disfigurement
  - Retirement at planned retirement age
- In all cases, some part of benefit taxable, some exempt
- Normal retirement : Participants are allowed to withdraw 25% of accumulated balance as tax-free lump sum upon retirement; remaining balance can be drawn down in the shape of regular installments; compulsory purchase of life annuity at age 75; payments other than lump sum taxable as income for the year

The VPS – Benefit Payouts

- Early retirement : accumulated balance available only at normal retirement age, tax treatment at that time similar to that of normal retirement
- Partial/total withdrawal : Accumulated balances can be withdrawn in totality or partially before retirement age; entire amount subject to tax as income for the year at average of last 3 years
- Death/Disability/Disfigurement : incase of the unfortunate disability of participant, he will be treated as having attained retirement age, regardless of the age at which he is at present.

  Incase of demise of the participant, his accumulated balance will be divided amongst his survivors as per nomination deed. Survivors can either withdraw amount as cash (taxable income for the year), or use amount as part of their own VPS balances

The VPS – The Way Ahead

- At present, VPS not at par with Provident Funds and gratuity as a statutorily acceptable benefit in the eyes of the labour law – needs to be put at par
- Also at a disadvantage in terms of taxation – either existing retirement funds should be taxed at payout stage, or VPS benefits should also be tax-exempt (E-E-E structure) at least in nascent stages
- Allow initial contribution for past service, similar to other corporate retirement benefit schemes
- Introduce the benefit as 'opt-OUT' rather than 'opt-IN' benefit – experience from US and UK shows that participation and contribution rates surge dramatically if the default choice is to participate/contribute

The VPS – Food for Thought

- Massive portion of potential contributors not financially savvy : fund manager selection from amongst many choices could be very difficult
- Who should make decision for them ?
- If employer makes participation default choice and introduces default fund managers and asset allocations : if fund manager performs poorly, who takes blame ?
- Employers open to legal action, therefore may hesitate to recommend manager and allocation
- Use of fund manager ratings agencies
- SECP, fund managers, rating agencies, employers need to work in unison to bring benefits of VPS and all it entails to the citizens of Pakistan

The End

Thank You