Box 4.2.1: Pension Funds in Pakistan

Pension Funds in the Context of Social Safety Nets

Social pension systems continue to be relevant to nations worldwide as they strive to ensure economic stability and security of their aging populations. Countries grapple with adopting a Multi-Pillar Pension System that has some participant-funded elements but also includes other options that allow States to extend effective old-age protection in a fiscally responsible manner.

Pakistan has been making efforts to strengthen its social security program to support the vulnerable. At the federal level, the Benazir Income Support Program complemented by smaller programs as the Zakat and Bait-Ul-Mal programs provide non-contributory social protection to alleviate general poverty. While state-mandated contributory retirement plans offered by employers in the formal sector provide consumption smoothing to the retired workforce.

The current pension system is considered ***inadequate*** as its coverage is confined to the formal sector employees, while a large portion of the labor force in Pakistan, either employed in the informal sector (especially the agriculture sector) or self-employed, remains uncovered. Another major issue is the system's ***sustainability***. Most of the pension schemes in our system are the unfunded Defined Benefit[204] wherein servicing burden lies with the employers.

The situation has led many employers (specially the private sector employers) to curtail pension benefits and switch to the defined contributory system wherein employers are liable to only pay out the defined amount and the financial risks of retirement savings are passed onto the employees who are themselves responsible for their investments and returns.

In case of public sector too, much of the pension liability remains un- funded. The future monetary obligations are taken to be met from future taxation, which places undue fiscal burden and responsibility on future generations. Age analysis of population suggests growing state pension expenses given the expected increase in the older age group. These conditions have led to reforms in the pension system increasingly stressing "funded" pension arrangements. Pension system reforms are focused on extending coverage to funded pension systems, which are professionally managed, extend to the informal sector, and facilitate switching from the existing employer schemes. While in the public sector, funds have been created at the provincial level to pre-fund the future liability.

Pakistan's Pension system -Regulatory perspective

The employer sponsored pension programs (called the Occupational Savings Schemes) are a product of Labor Laws and have been formulated with the core objective of increasing pension coverage. And FBR only regulates these schemes from a tax standpoint. Underlying different objectives, these regulations failed to address the peculiarities of a pension legislation- most importantly safeguarding pension savings by laying out criteria to discipline investments in a way that curtail risks without compromising returns.

SECP assumed the role of a Pension regulator with an amendment in Securities and Exchange Commission of Pakistan Act, 1997 in 2003[205], which expanded its

[204] There are two types of pension schemes i) Defined Contribution (DC) and ii) Defined Benefit (DB). In a DC plan, only fixed contributions (determined on the basis of the worker's age, earnings, contribution rate, investment return and normal retirement age) are made into individual accounts of employees by both employer and employee. Accumulated retirement amount is paid out by employer but this amount may be insufficient to cover the remaining life of the covered employee. Hence, the risk of insufficiency of funds in the future is borne by the employee. In a DB the retirement benefits are known (e.g. they will be provided for the entire period that the employee lives) throughout. Contributions depend on the amount that will be required to fund the future benefits that the employer has promised. Even if the investments returns are below par, employer must pay the promised benefit. An actuary determines the amount that shall be contributed to produce the desired benefits taking into account factors as length of service, level of wages etc. Regular pension amounts that are paid for the entire life of an employee and medical benefits are defined benefit plans. Unfunded plans refer to those wherein pension assets are less than pension liability/obligation.

[205] https://www.secp.gov.pk/document/secp-amendment-act-1997-for-your-information-and-record/?wpdmdl=17801

responsibilities to include promotion and regulation of Private Pension Schemes and Funds. Accordingly, the Voluntary Pension Rules were introduced in 2005, which more tightly regulate the pension products sold to individuals or institutions.

Mapping Pakistan's Multi-Pillar Social Pension system to the World Bank Model

Table 1

Multipillar Pension Taxonomy- World Bank

Pillar	Target Group			Main Criteria			Pakistan's System of Social Pension
	Lifetime Poor	Informal Sector	Formal Sector	Characteristics	Participation	Funding or collateral	
0	X	X	x	"Basic" or "social pension," at least social assistance (universal or means tested)	Universal or residual	Budget or general revenues	Benazir Income Support Program(BISP), Pakistan Bait-ul-Mal
1			X	Public pension plan, publicly managed (defined Mandated Contributions, benefit or notional defined contribution) perhaps with some financial reserves	Mandated	Contributions with some financial reserves	Mandatory State pension ,State-mandated registration with EOBI(industrial and commercial enterprises employing more than 5 employees)
2			X	Occupational or personal pension plans (fully Mandated Financial assets funded defined benefit or fully funded defined contribution)	Mandated	Financial assets	Occupational Saving Schemes with Private sector employers, Workers Welfare Fund(WWF)
3	x	X	X	Occupational or personal pension plans (partially or Voluntary Financial assets fully funded defined benefit or funded defined contribution)	Voluntary	Financial assets	Voluntary Pension Scheme
4	X	X	X	Access to informal support (family), other formal Voluntary Financial and social programs (health care), and other individual nonfinancial assets financial and nonfinancial assets (homeownership)	Voluntary	Financial and nonfinancial assets	Pakistan Poverty Alleviation Fund(PPAF), Microfinance Institutions

Source: World Bank

Note: Size of x is reflective of the importance of each pillar for each target group in the following increasing order of importance: x, X, X

Parallels can be drawn between the social pension systems in Pakistan to that of the five-pillar model suggested by the World Bank in 2005 (**Table B3.5.6**). The model suggests that ideally in low-income countries, the zero pillar should be the dominant form of protection against old-age risk. But since in many of these countries, both the public and the private sector are unable to deliver sufficient coverage, the model suggests that the third pillar (voluntary pensions) should be promoted with the basic zero pillar confined to providing for the basic needs of the most vulnerable.

Voluntary Pension Scheme in Pakistan

The Voluntary Pension Scheme (VPS) in Pakistan was established to move beyond the conventional concentration on the first and second pillars so as to i)provide for effective old age protection in a fiscally responsible manner, ii) extend coverage to the workforce of the informal sector and iii) allow differential amounts of coverage for employees than those available under EOBI .

Features of the VPS

VPS is a tax-advantaged defined contribution scheme under which contributions can be made in lump sum or regularly, to provide regular income during retired life. The scheme is available to employed/self-employed individuals wherein besides the employees their employers may also contribute to provide regular income during their retired life. Tax credit can be availed at the average rate of tax on the amount of actual contribution or 20 percent of annual taxable income whichever is lower. For those joining at 41 or above an additional credit of 2 percent is allowed for every year over 41 years of age, up to a maximum credit of 30 percent of the taxable income of the preceding year. Contributions can be made in lump sum or regularly with annual tax credit of 20% of taxable income. Further, the Contributions made by the Participants and/ or their employers (if any), plus the investment income, are accumulated tax free in the Sub-Funds until the Participant retires.

Participants of VPSs can change their Pension Fund Manager or the Pension Fund, once a year by giving 21 days prior notice. Further, participants can choose to change their selected Allocation Scheme, twice a year.

Individuals can choose among the specified allocation schemes a as per their risk appetite to achieve desired diversification. A pension fund must offer four pension allocation schemes for three or four sub-funds[206] as tabulated below (**Table 2 & 3**):

Table 2

Three Sub-Fund allocation schemes allowed to Pension Funds

Allocation Scheme	Equity Sub-Fund	Debt Sub-Fund	Money Market Sub-Fund
High Volatility	Min 65%	Min 20%	-
Medium Volatility	Min 35%	Min 40%	Min 10%
Low Volatility	Min 10%	Min 60%	Min 15%
Lower Volatility	-	Min 40%	Min 40%

Source: SECP

Table 3

Four Sub-Fund allocation schemes allowed to Pension Funds

Allocation Scheme	Equity Sub-Fund	Debt Sub-Fund	Money Market Sub-Fund	Commodity Sub-Fund
High Volatility	Min 40%	Min 20%	-	Max 25%
Medium Volatility	Min 20%	Min 40%	Min 10%	Max 15%
Low Volatility	Min 05%	Min 60%	Min 15%	Max 05%
Lower Volatility	-	Min 40%	Min 40%	-

Source: SECP

Besides this, some pension funds can also offer other allocation schemes as lifecycle products. Under these products, younger individuals can choose riskier/aggressive investments portfolios that are inclined towards equity funds and vice versa. Further, in the event that no allocations are chosen by an individual, pension fund manager shall allocate preferably to an approved lifecycle allocation scheme if available based on the age and risk profile. A typical lifecycle scheme may look like this (**Table 4**):

Table 4

A typical Life Cycle Allocation scheme

Plan	Equity Sub-Fund	Debt Sub-Fund	Money Market Sub-Fund
18-30 years	75%	20%	5%
31-40 years	70%	25%	5%
41-50 years	60%	30%	10%
51-60 years	50%	30%	20%
61 and above		50%	50%

At retirement, a participant can choose any one of the following:

- Encash up to fifty per cent of the amount accumulated in Pension Account tax free and remaining by paying tax as per Income Tax Ordinance 2001.
- Purchase i) an Approved Annuity Plan from a Life Insurance Company that pays regular income; or ii) an Income Payment Plan with Pension Fund Managers for monthly installments for fifteen years. This option is more suited for those willing to take some risk to earn incremental returns.

Performance and trends in Pension Funds

Pension funds have steadily been increasing with ten pension fund managers managing 19 funds. In CY17, the pension funds' AUMs stood at PKR 24.1 billion with investor accounts of 27,725. Islamic fund were the dominating category with PKR 15.2 billion assets.

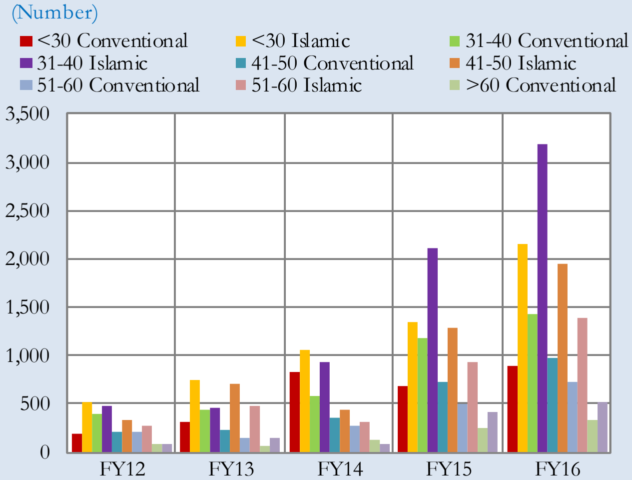
[206] Besides the equity, income and money market sub-funds, the commodity sub-fund was introduced in a pension fund under circular No. 6 of 2013 dated May 09, 2013. This commodity sub-fund shall invest in only commodity future contracts that are traded at the PMEX and are cash-settled futures (except gold which can be invested in a deliverable future contract).

Age analysis of the participants reveals that in terms of number around 34 percent of the participants are in the middle age bracket (31-40 years) which is an encouraging sign (**Figure 1**). In terms of amount, the total amount invested by the 51-60 year category dominates (43.4 percent of total AUMs) suggesting build-up over time. Comparison of retirement funds' investments in mutual funds with the size of VPS reveals that retirements funds prefer investments in mutual funds rather than their specialized product available for old-age security i.e. VPS. The size of the VPS is almost a third of the provident/pension funds' investments in mutual funds (**Figure 2**). This is probably due to difficult administrative burden for employers to manage an individualized pension plan for an employee. Until employers take the initiative to invest their retirement funds in VPS, or employees make the choice of opting for putting their employment fund contribution under the VPS, growth of this segment will remain subdued.

Figure 1
Age-wise analysis of Pension Fund Investors

Islamic products are more popular with pension funds

(Number)

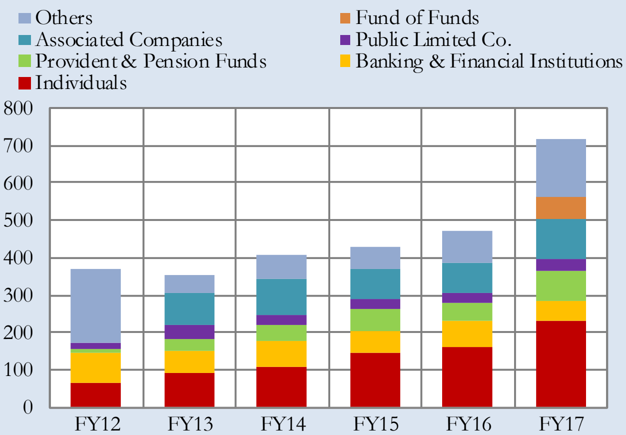


Source:MUFAP

Figure 2
Investor composition of mutual funds

Provident/Pension funds' investments in mutual funds is more than double the size of VPS

(PKR billion)



Source:MUFAP