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Mitigating the Risks in Pension Provision

- What are the risks from the perspective of Government, Employers and Individuals

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Asia and Pension – the big picture

Structure of Social Security set up in Asia

- Generally provision for old age retirement, death and disability in employment and health care financing are not well integrated.
- Government sector Social Security needs are usually provided for separately from that of the private sector. Usual to have defined benefit pensions for the government sector and lump sum for others.
- The generally large informal sector (self employed) and unemployed (including housewives) are usually not included under the formal Social Security umbrella.
- Mixture of funding arrangements are evident, from funded through direct taxation, employees and employers contribution.

Structure of Social Security set up in the ASEAN Region

- Defined Benefit arrangements are probably being mainly funded through a Pay as you go arrangements.
- Defined Contribution arrangements generally includes some form of members choice and prior retirement lifecycle withdrawals
- Approach to Social Security provision seem to have developed through reactions to needs as it arises, this has resulted in unintegrated/silo approaches to provision of old age, health care, invalidity and dependents benefit. This can result in overlaps or gaps in benefits and inefficient use of resources (expensive).
- Generally underdeveloped private sector third pillar in most countries.

Is there a problem brewing…

- Current demographic and family structure in most Asian countries have shielded governments from having to deal with old age problems currently faced by more developed countries
- Defined Benefit schemes are basically funded on a pay as you go basis and again due to existing demographic structure, has yet to be tested

The Stakeholders and their interests

The elected Government

- Primary objectives of government includes
  - Ensuring (near) full employment
  - Controlling inflation (which includes balancing the budget)
  - Balancing the country’s international trade account / currency management
  - Improving the population’s standard of living
- The assets the government has at its disposal includes
  - Its people, their entrepreneurial spirit and their capital
  - The country’s natural resources
  - The country’s capital stock built up from previous investments
- In managing the country the government uses several tools including
  - Fiscal policy, setting the basis of taxation
  - Monetary policies, primarily managing interest rates, normally determined independently by the Central Bank

The good Employer

- The objectives of a good management would include
  - Increasing shareholders value
  - Keeping a happy and productive workforce
- The assets the management has at its disposal includes
  - Its trained workforce
  - Its brand name and other intellectual property
  - Its capital
- In managing the company the management uses several tools including
  - Competitive pay and benefits to retain the best staff
  - Ensuring resources are utilized where they can provide most value to shareholders

The good Employee (and breadwinner)

- The objectives of the individual would be
  - Maximize pay and benefits (he can take either a short term or long term view when determining this)
  - Manage a healthy and comfortable lifestyle for himself and his family
- The “asset” the employee brings to the table includes
  - His knowledge
  - His labor to the employer

The Individual

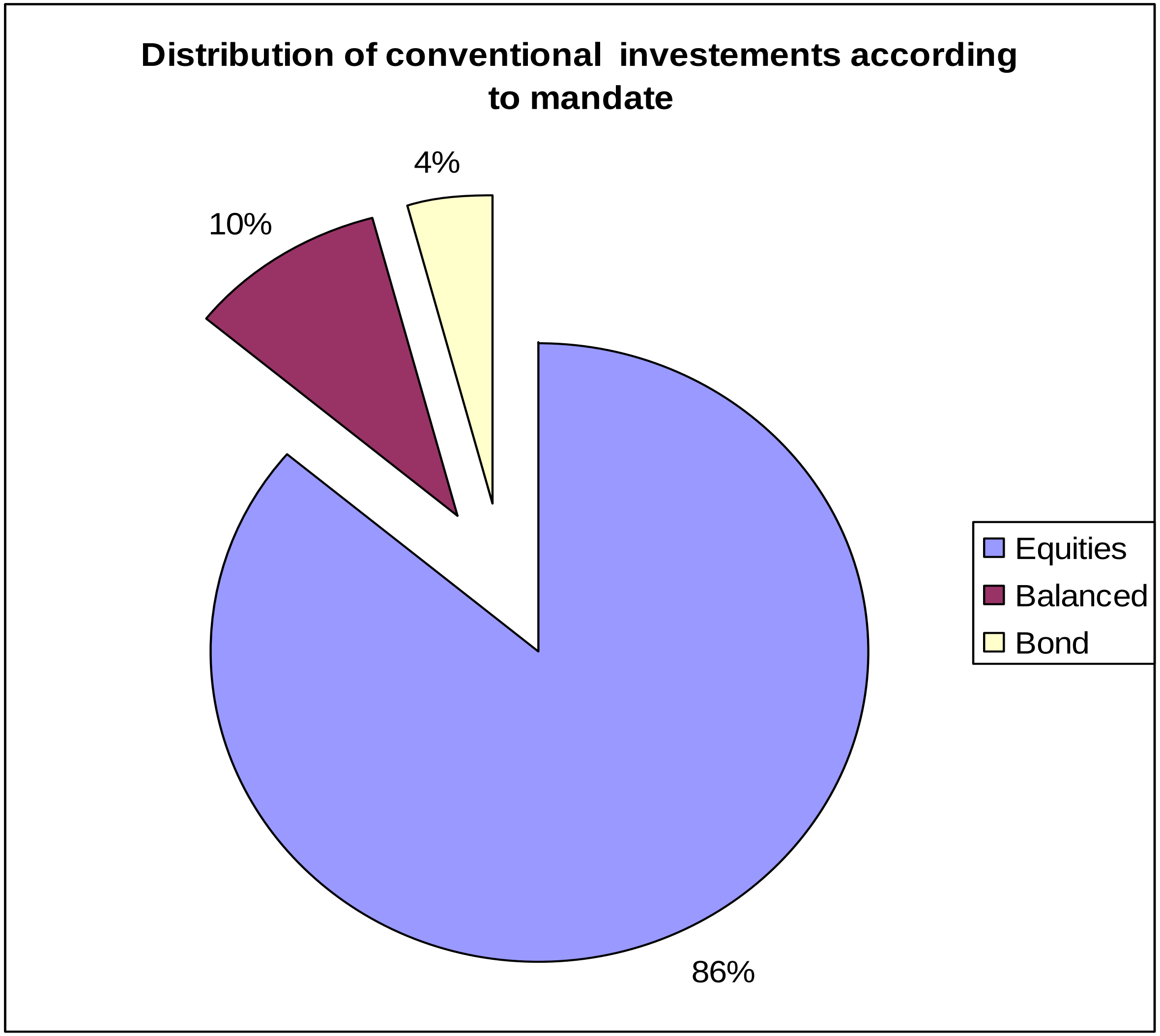
The Individual’s dilemma

- The individual has at its disposal limited resources, the value of which normally increases with working experience but then rapidly diminishes with the onslaught of mortality
- The level of the individual’s wealth defined in terms of material wealth, knowledge and level of health can vary significantly between individuals and country to country
- The ability to save and the knowledge of how best to ration one’s wealth is fraught with risks including
  - Employment uncertainty
  - Family commitments
  - Level of health

Behavioral investment traits of the individual investor

- Very short investment time horizon (2 to 5 years perhaps, max) and are rarely rational investors usually acting on impulsion
- Understanding of money and risk is limited resulting more often than not in “mispricing” of risk, for example
  - Herd mentality leading to asset bubbles
  - Popularity of expensive capital guaranteed investment products with very little upside potential
- Individual investors are rarely organized as a consumer group thus often resulting in ending up paying too much for services rendered
- Are less likely to hedge (e.g. buying annuity to hedge against the risk of longevity) and more likely to take a punt
- All these traits makes leaving the planning for retirement purely to the individual a recipe for disaster

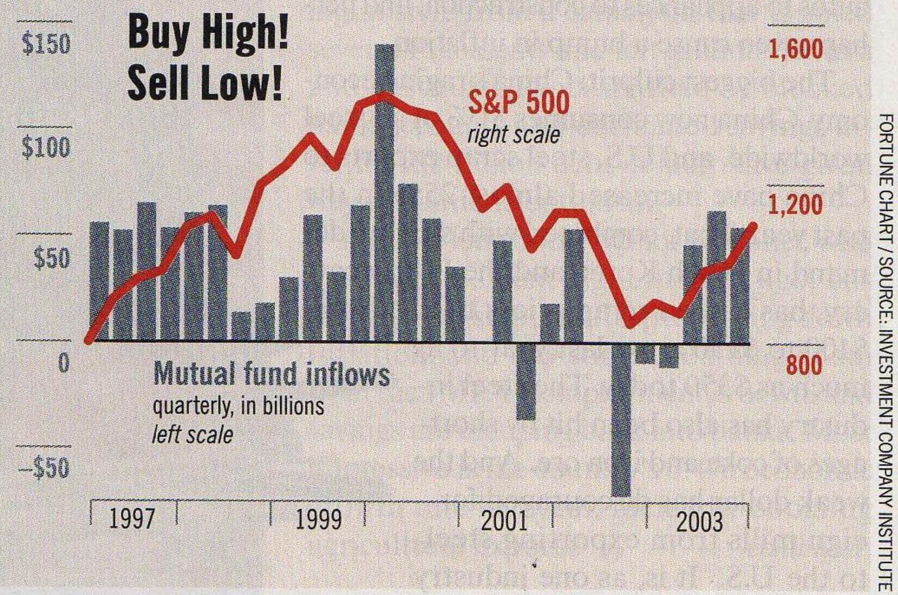
Distribution of Investment of EPF members in the SPA Scheme According to Mandate – certainly not risk adverse



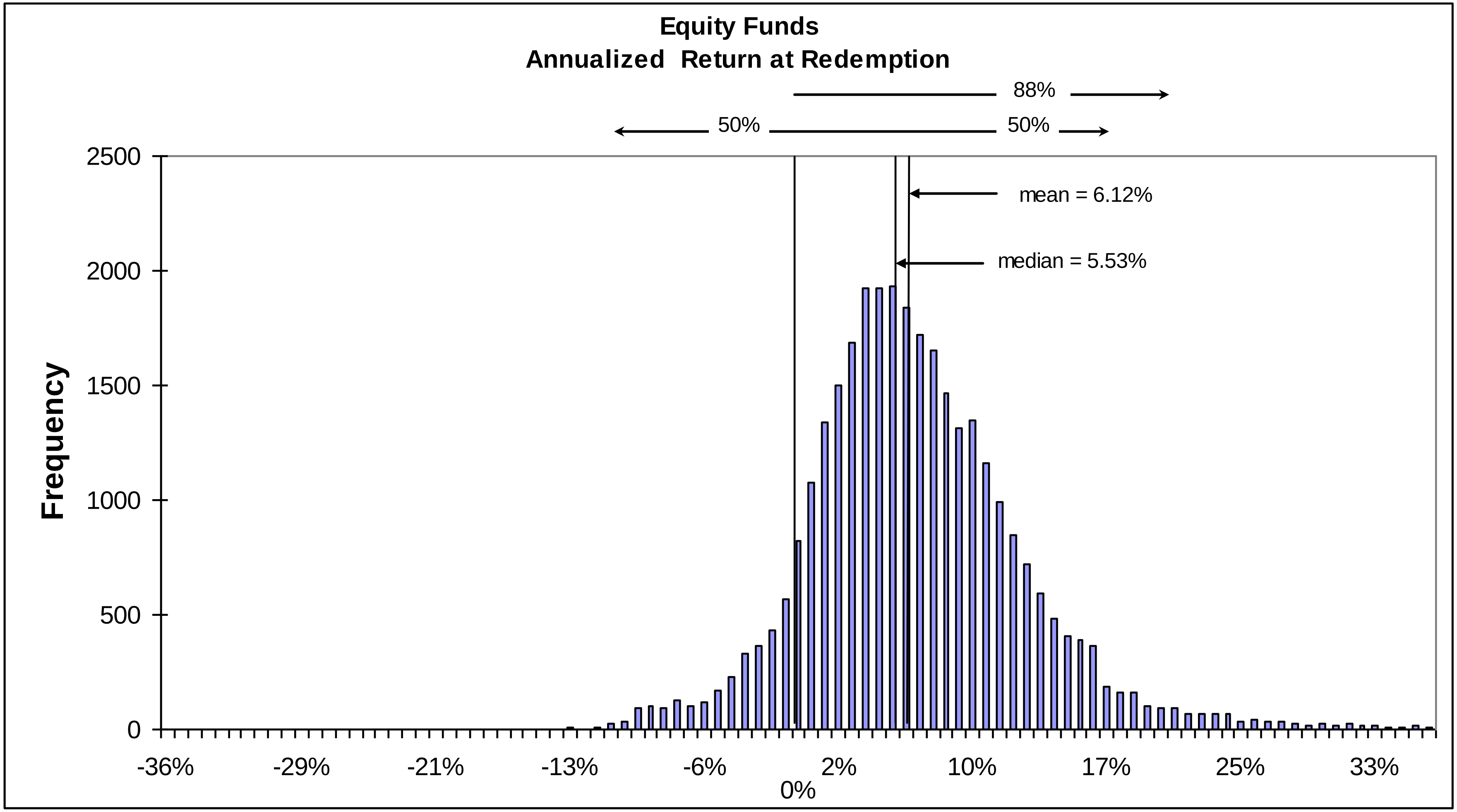
Mutual Fund investment – market timing and the individual investor

by the numbers

The market is back—oh, the joy of it—and so are investors. But should they be? It's not a shock that the average investor can be less than rational. But whatever happened to the notion of "Buy low, sell high"? The chart at right, which compares net inflows into equity mutual funds with the performance of the S&P 500 over the past seven years, demonstrates that investors pile in when the getting is good and flee when stocks are falling. That's precisely the opposite, needless to say, of what they should do. Not only do fund investors react immediately to the gyrations of the S&P, they also often overreact, displaying a volatility normally more associated with, well, the stock market. Buy high, sell low? Poor Benjamin Graham is turning over in his grave. — *Matthew Boyle*



Investment Returns for a group of investors tend to be normally distributed - sample survey of mutual fund investors performance



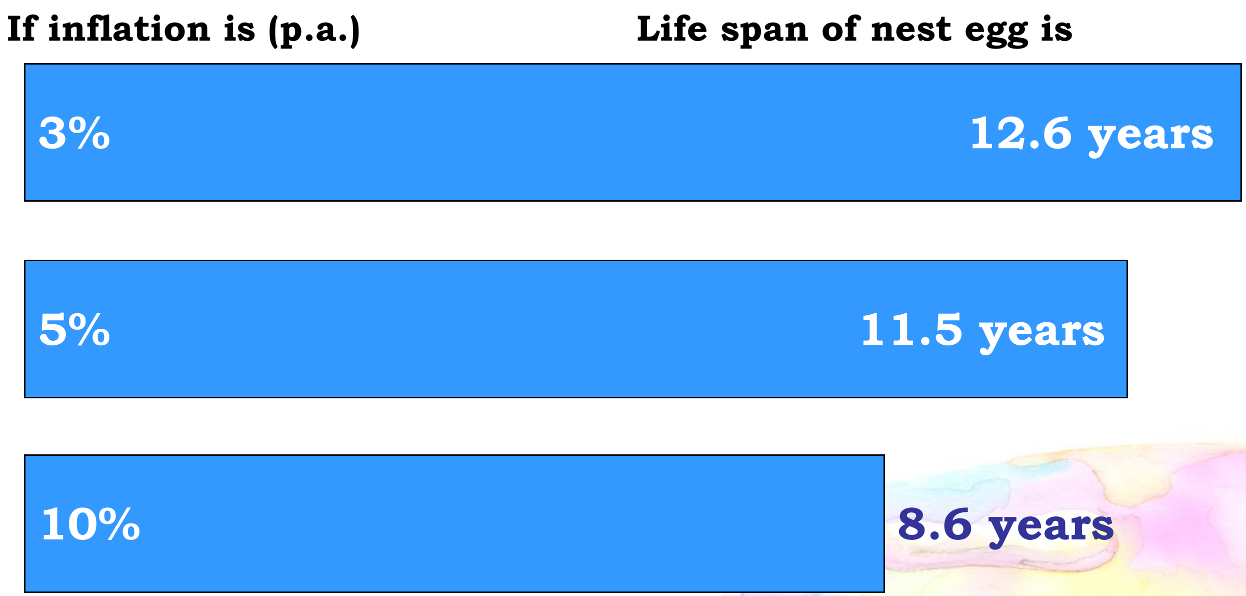
Adequacy of retirement savings

- The average amount withdrawn on retirement at age 55 by recently retired EPF members has been reported to be RM100,000 only.

- Comparing with the US, a survey by the Employee Benefit Research Institute reveals that only 21% of household have accumulated more than US$100,000 in retirement savings while 35% has nothing saved for retirement.

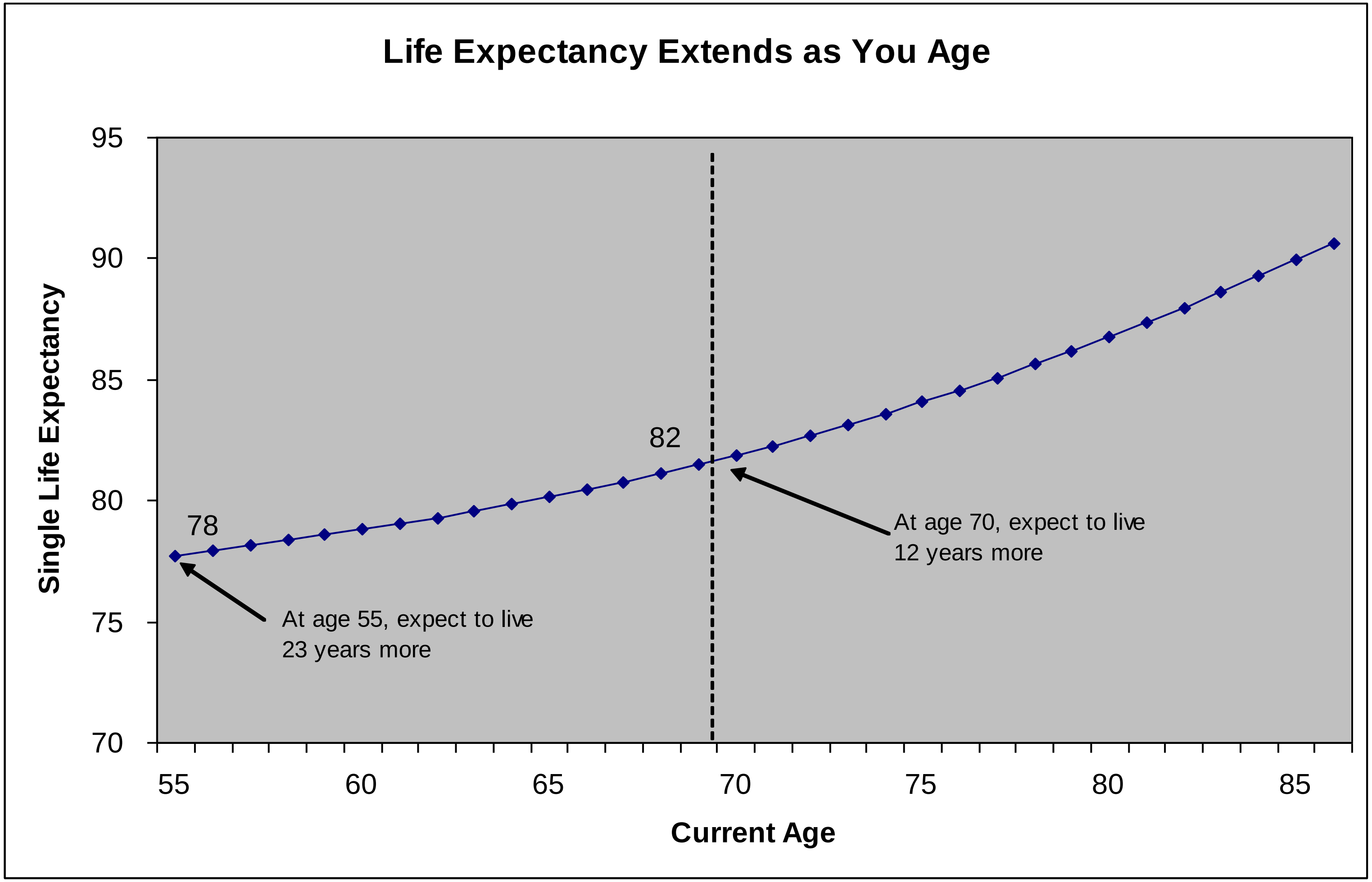
- The sufficiency of any amount saved at retirement depends the retirement age, longevity, the retiree's lifestyle and most importantly the interplay between investment income and inflation.

How long a lump sum retirement saving will last assuming different inflation rates?



Assumptions: *RM100,000 capital*
Withdraws RM10,000 in 2006 ringgit every year
6% per annum return on investments

Life Expectancy Extends as You Age



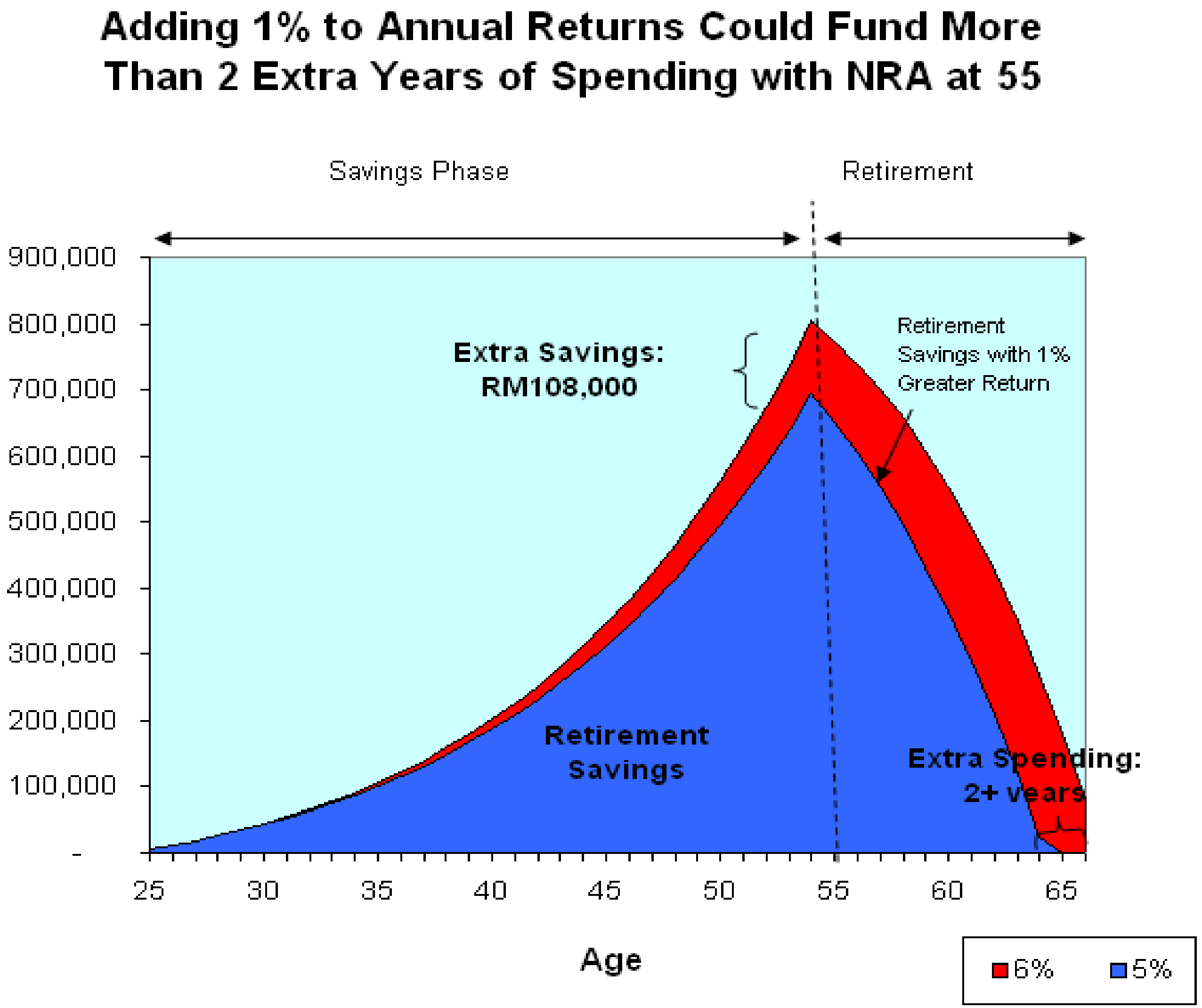
Assumptions for projections:

Retirement Age:	55	EPF Dividend Rate:	5% p.a.
Age at entry:	25	Monthly Salary at entry:	RM2,000
Employer contribution:	12%	Salary increment rate:	5%
Employee contribution:	11%	Inflation rate:	3% p.a.

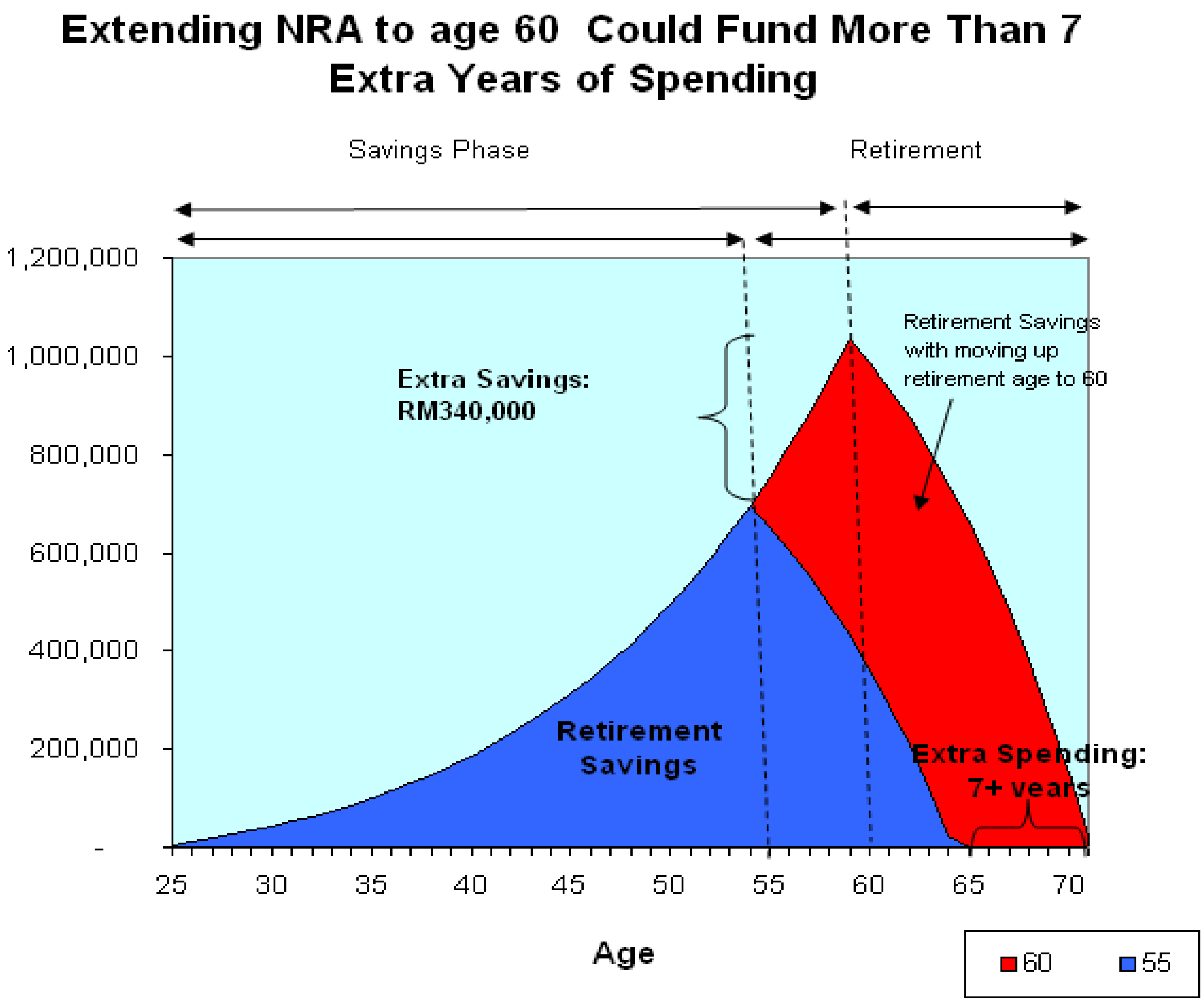
No pre retirement withdrawal from Account II. Money invested after retirement earns 5% p.a.

Assumed drawdown of 75% of final salary at retirement. Ringgit amount subsequently inflated at 3% p.a.

Adding 1%p.a. to annual returns or alternatively saving 1%p.a. in investment expenses could fund more than 2 extra years of spending with NRA at 55

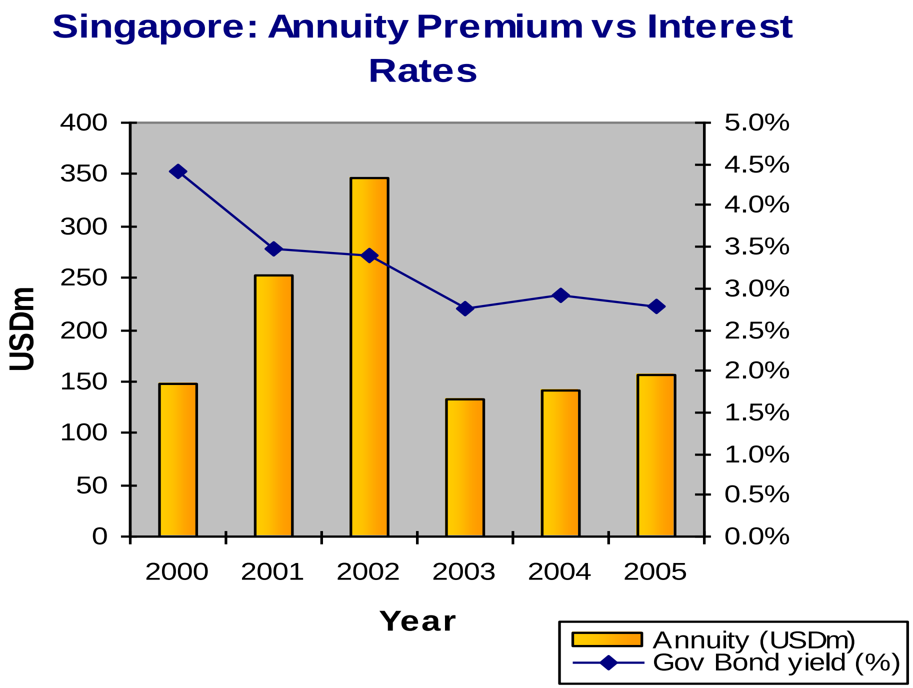


Extending NRA to age 60 could fund more than 7 extra years of spending



Singapore new single premium annuity purchase growth mapped against interest rates prevailing at time of purchase

	2000	2001	2002	2003	2004	2005
Annuity (USDm)	148.6	251.5	345.9	132.8	140.2	155.7
Gov Bond Yield (%)	4.4%	3.5%	3.4%	2.8%	2.9%	2.8%



The other stakeholders and the role of government

Differences between stakeholders

- The employer’s longevity is by no means assured
- There will always be a drive for growth and greater profits. Obviously in any one industry this cannot go on forever resulting in a boom and bust cycle
- The government’s longevity is also by no means assured. Ultimately it is the people who decide on the government. The role of government is to manage and ultimately improve on the quality of life enjoyed by the population. This is determined directly by the policies adopted by the ruling elite.

The inevitable facts

- The aging population, the decreasing fertility and the breakdown of the family unit means that the individual worker face an uncertain retirement
- By itself the employer has little interest in managing the retirement of its employees. Providing for employees retirement is certainly not part of a company’s core service or indeed expertise
- Ultimately it would be the government’s responsibility to ensure the aged is taken care of. It is pertinent to note that the risks associated with pension provision – longevity, inflation and return on investment are all within the “control” of the government. Governments have a heavy influence on how these risks manifest itself over time.
- While the employer’s responsibility to its employees usually ceases at retirement, the government’s responsibility does not. Indeed the retirement agenda will slowly move itself up in priority as the electorate ages.

The Government’s role in ensuring a comfortable retirement for its citizens

- Of the three stakeholders the government would be working with the longest time horizon.
- Pension issues cannot be addressed in isolation to the issue of social security and health care provision. **An integrated approach would cut down on leakage and wastage within the whole system**.
- Need to identify the role of the individual and the employer in the scheme of things taking into account the limitations faced by each stakeholder (e.g. recognizing the employers loathing for expense volatility associated with DB schemes and the limited ability of many individuals to make rational long term retirement decisions without guidance).
- Market forces by itself cannot assure that the majority of the population would be provided with adequate retirement provision. **The government’s focus is with the majority rather than any individual groups.**

Pension risks and how governments can play a role

- **Longevity Risk**
  - The issue is one of the decumulation period. Raising retirement age compensate for increasing longevity and diminishing return on investments
- **Interest rate risk**
  - The increasing use of interest rates to manage the economy can play havoc on a pensioners income. Why should the innocent by stander, the pensioner, be affected by the excesses of the working population? Appropriate financial instruments should be created to protect pensioners (real) income
- **Investment risk**
  - Ensure the pension investor has access to best advice and act on such advice. Government policies need to ensure the alignment of interest of the service provider and that of the pension investor.

Summary

- Planning for retirement starts with the government. Monetary and fiscal policies influences how the pension “market” develops.
- Given that pension is a part of the bigger issue of provision of social security to the population, an integrated approach to the problem would limit gaps and maximize the utilization of a nation’s precious resources.
- Defined benefit plans providing for pension for life is still the best option to the individual but it is unlikely to happen for the majority of retirees. Managing Defined contribution plans is much harder as the unit of risk is the individual rather than a “pension scheme”.
- **The government, the employer and the individual should share in the risks associated with retirement provision.**
- **For this to work the interests of all stakeholders have to be aligned. Only the government is in a position to manage this alignment.**

You can be young without money but you can’t be old without it.

Tennessee Williams

Thank You

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