VPS – A NEW FOUNDATION FOR RETIREMENT INCOME SECURITY

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It is a well-known fact that all successes in life start from a desire for a better future. According to Napoleon Hill, "Desire is the starting point of all achievements." But remember that success does not just happen; it requires a plan of action and a commitment to stick with it. Just a little preparation and a proactive approach to reach goals can make a big difference in tackling challenges and the uncertainties of life. When we look at life, it becomes self-evident that there is a natural progression of everything. First we go through infancy, childhood and teenage and then comes our working phase, marriage, family and finally retirement. There is a time for everything and therefore we need to plan everything well ahead of time even if it's years and years away. We know that future stability is something that needs to be worked on today as our tomorrow is influenced by the choices and decisions we make today. When making decisions that affect the future prosperity, the first step is to acknowledge that financial situation changes over time. Retirement is a major life transition that requires some planning today for life after retirement. How well you live after retiring depends on how well you plan for it. According to Arthur E. Morgan, "Preparation for old age should begin no later than one's teens. A life which is empty of purpose until 65 will not suddenly become filled on retirement."

Why retirement planning is necessary?

Retirement planning helps individuals to become self-reliant in old age. When we are talking about retirement, a lot of people especially the younger generation tends to think that this issue isn't so important for them, since they feel it is something far in the future. In nature, people like to live and think for today, instead of thinking about something unclear, especially if the issue is 25-30 years ahead from now.

Early retirement planning is the best option when preparing for your golden years. The costs of living will continue to rise, and many individuals want to retire early. Retirement is not going to just happen, at least not the way you dream of, so it is important to plan ahead and map out the road to a successful retirement that is similar to what you have always wanted. Starting investing as soon as possible will allow you to be flexible and have several different options and will let you receive more benefits and income from compounding interest, so you will reach retirement with a nest egg that is the right size for your retirement needs, possibly even more. Therefore, it is advisable to start early, otherwise, we can become burden on our children or family when we get retired without sufficient amount of money to spend.

Assume that we started our career at our 25 years of age, then how many years time we have before retired? Up to 60 years old, there will be 35 years. Yes, we have 35 years to prepare. After that, if we live up to 75 years old, how much time we have to spend without any significant income but just continuous monthly expenditure? 15 years. It means, we have 35 years to secure our next 15+ years life (almost 1/2 of productive life period). To be emphasized here, 15+ years is not a short time, and at that time we will need something to spend for our daily life.

So, to begin our retirement planning at 40 years of age is little bit too late unless at that time we have quite huge income to allocate. But, who can grant that our 40 years age will become our financial golden age?

Retirement Benefits in Pakistan

In Pakistan, a state level pension system (on the structure of social security/ minimum pensions as exists in the developed countries) does not exist. People generally rely on the joint family system, wherein the younger generation is expected to support the older generation in their post retirement phase. Today, this structure has already started to show cracks, especially in the low-income group and this can only be expected to compound with the passage of time. Demographics are changing, with life expectancies increasing with time and problems of aging population in our country will be further compounded than developed markets because of the following reasons:

- Low savings rate
- Very limited retirement benefits & not available to masses
- Inflationary pressures - Cost of living increasing/ real value of money declining

Existing Retirement System

The bulk of the population does not have access to any pension system to supplement their income once they reach a retirement age. Only 32% of the population is employed, out of which 70% is in the rural area and 30% in the urban area. We can easily assume that 90-95% of the rural population has no employment benefits.

Selected Demographic Indicators (2010-11) (million)	
Total Population	177.1
Urban Population	65.3
Rural Population	111.8
Labor Force	57.24
Unemployed	3.40
Employed Labor Force	53.84

Source: Labour Force Survey 2010-2011

Employment status - (2010-11)

	Urban (mn)	Rural (mn)	Total (mn)	Share (%)
Employers	0.53	0.24	0.77	1.43%
Self-Employed	5.01	13.76	18.77	34.86%
Unpaid Family Helpers	1.83	13.08	14.91	27.69%
Employees	8.62	10.77	19.39	36.01%
Total Employed Workforce	**15.99**	**37.85**	**53.84**	**100.00%**

Source: Labour Force Survey 2010-2011

Employment shares by industry (2010-11)

Major Industry Divisions	Employed (mn)	Share (%)
Agriculture/Forestry/Hunting & Fishing	24.29	45.1%
Mining & Manufacturing	7.38	13.7%
Construction	3.78	7.0%
Transport/Storage & Communication	2.75	5.1%
Wholesale & Retail Trade	8.73	16.2%
Community/Social & Personal Service	5.82	10.8%
Others	1.09	2.1%

Source: Pakistan Bureau of Statistics, Labour Force Survey 2010-2011

Public Sector

Amongst the employed, the Government remains the biggest employer and the pensions provided by the Government to public sector employees are defined benefit in nature and are on a pay-as-you-go (PAYG) or unfunded basis. The unfunded defined benefit system places substantial funding burden as well as enormous fiscal strain on the government as no assets are set aside earlier to pay benefits later. This in itself is a big issue and challenge that not only the Government in Pakistan, but what the Governments all across the world are facing. Defined benefit arrangements are under financial pressure as the PAYG state pensions are no longer affordable with current & future demographics and these countries are now introducing pension reforms to shift from the defined benefit to defined contribution setups and from un-funded to funded schemes. This is a challenge which our Government needs to address and the earlier the better for our economy.

Private Sector

In the private sector, pension schemes, provident fund and gratuity schemes are amongst the most commonly offered retirement benefits. But this is relatively undocumented, unregulated segment and covers only a small portion of the population. Amongst these both pension and gratuity schemes are mostly defined benefit in nature and generally under or unfunded. Provident funds are the only scheme that is defined contribution in nature.

Very few companies, mainly multinationals are offering pension schemes to their employees. Gratuity schemes are the most commonly offered retirement scheme, especially in the textile sector and they are primarily un-funded. Other than being un-funded the biggest disadvantage that all these three schemes have is the lack of portability and no penalty for an early withdrawals. Hence the money can be used by the employees when they need cash and the entire balance is paid to them when they leave employment, instead of at retirement. Even at retirement, both Provident and Gratuity Schemes provide a one-time lump sum payment of entire retirement account balance while the primary purpose of a retirement plan is to substitute the monthly income once we stop working. And from pension schemes also the amount can be withdrawn as a lump sum. Taking all the money at once increases the chances of running out of money quickly as it is difficult to resist the temptation to spend more.

Along with the easy access on withdrawal from these schemes, the schemes which are funded, including the defined contribution provident funds, are not properly invested. Employers tend to err on the "too conservative" side, thereby placing the funds in bank deposits or fixed income schemes that at the end of the day are unable to earn returns over inflation.

Furthermore, as can be seen in the 'Employee Status' table, a sizeable portion of our population is self-employed and thus does not qualify for the state/employer provided pension plans. Additionally, the culture of joint family system puts considerable pressure on next generation to provide for their elderly people during retirement.

Voluntary Pension System

Having a proper pension system in place reduces finance liability for governments, relieves financial obligations for younger generations, shifts responsibility from the state to employers, employees and individual citizens, boosts economic growth and supports the bond and equity markets. Recognizing the need to substantially overhaul the pension system to build a new, stronger foundation for an efficient and effective retirement income system for the future retirees, Government of Pakistan took the first step towards introducing pension reforms in the country with the introduction of a new defined contribution system i.e. voluntary pension system in January 2005.

The Voluntary Pension System is a voluntary, self contributory pensions savings scheme based on defined contribution system where all Pakistani citizens over the age of 18 with a valid Computerized National Identity Card (CNIC)/ National Identity Card for Overseas Pakistanis (NICOP) for non-resident Pakistanis or a National Tax Number (NTN) can create their pension account with any of the approved pension fund managers. This is the only scheme that provides retirement security to both salaried and self-employed individuals. The pension account will stay with the investor even when they change jobs. Contribution can be resumed at any time either through the new employer or through personal contribution, without any charge or penalty.

This new pension system has been shaped with an eye towards designing a coherent set of policies that promote individual and national savings and encourage credibility and efficiency of private pensions through implementation of stronger supervisory policies. DC plans have the advantage of providing employees with choice, control and portability, while reducing the uncertainties and burdens on plan sponsors.

There are many advantages of investing in voluntary pension schemes but it's worth discussing a few of them here:

At Contribution Stage

- Amount and frequency of contribution:
  - An individual can contribute any amount they want to and contributions can be as a lump sum amount or regularly through monthly, quarterly, half-yearly or yearly installments.
  - Employers can also contribute on behalf of their employees.
- Contributions to be invested in specially set up mutual funds, with flexibility of individualized asset allocation through individual accounts.
- Tax credit: To incentivize contributions, individuals can also avail tax credit on amount of actual contribution or 20% of annual taxable income whichever is lower.
- Multiple pension accounts: Individuals can diversify savings amongst more than one pension fund manager.
- Transfer of pension account: Under the new voluntary pension system, participant is allowed to transfer balance from one pension fund manager to another pension fund manager without bearing any cost.

At Investment Stage

- Sub-Funds: VPS is a one-window operation which provides investments in a diversified portfolio of equity securities and fixed income instruments. This is the only retirement scheme in Pakistan offering three sub-funds with the option available to the investor to choose an allocation that suits their specific requirements.
  - Equity Sub-Fund: The objective of the Equity sub-fund is to achieve long term capital growth by investing in listed equity securities.
  - Debt Sub-Fund: The objective of the Debt sub-fund is to provide income along with capital preservation by investing primarily in tradable debt securities of medium to long term.
  - Money Market Sub-Fund: The objective of the Money Market sub-fund is to provide regular income along with capital preservation by investing primarily in short term debt securities.
- Individualized Allocation Schemes: Participants can choose the portfolio mix and can change it over time to reduce the volatility of portfolio as they approach and enter retirement. The contributions made in the VPS are allocated the units of sub-funds at Net Asset Value, as per the Allocation Scheme selected by individual. The details of the allocations schemes are as follows:

Allocation Scheme	Suitable For	Equity Sub-Fund	Debt Sub-Fund	Money Market Sub-Fund
		Minimum investment*		
High Volatility	Investors with long term investment horizon and/ or high tolerance for risk.	65%	20%	Nil
Medium Volatility	Investors with long to medium term investment horizon and/or moderate tolerance for risk.	35%	40%	10%
Low Volatility	Investors with medium to short term investment horizon and/or lower tolerance for risk.	10%	60%	15%
Lower Volatility	Investors with short term investment horizon and/or very low tolerance for risk.	Nil	40%	40%
Life Cycle Allocation	Investors wanting to adopt a systematic investment approach.	Starting with a higher equity investment allocation for an individual aged 18 years, the equity allocation is gradually reduced and transferred to Debt and Money Market Sub-Funds as an individual approaches the age 60 years. Varying allocation between the Sub-Funds in accordance with the age and risk tolerance capability of the Participant.		
Customized Allocation	Investors wanting to adopt a customized investment approach.	0-80%	20-75%	0-60%
* Total allocation to be 100% between the sub-funds.				

- Mandatory Reallocation between Schemes at least once a year to maintain selected allocation percentages.
- Income to grow tax free: Sub-Funds will not distribute dividends but are totally exempt from tax.

At Retirement Stage

- Selection of retirement age: Investor has freedom to choose retirement age any time between ages 60 – 70 and in case of any permanent disability, participant can choose retirement age earlier.
- Option to take 50% balance at retirement: Participants are allowed to withdraw 50% of accumulated balance as tax-free lump sum amount upon retirement.
- Monthly Instalments from Income Payment Plan: The remaining amount can be drawn in the shape of regular monthly instalments over the lifetime of retiree through Income Payment Plan managed by the Pension Fund Manager. These payments are tax-free subject to the condition that the accumulated balance is invested in the Income Payment Plan for a period of 10 years.

As the purpose of the VPS is to promote savings for retirement and provide a monthly pensions for the individuals to supplement their income after retirement, any withdrawals before retirement age or in excess of allowable lump sum at retirement will be subject to withholding tax.

Conclusion

Defined contribution plan has the potential for generating meaningful retirement income, as it is focused on providing participants with an adequate and secure retirement income. Today, investors have several choices when it comes to choosing pension funds. We just need to save a part of our income on a regular basis and start investing in pension fund for a carefree post-retirement life.

The promotion and growth of schemes like VPS would help develop saving habits among the masses in the country and help them become self sufficient and maintain their standard of living after retirement. VPS is a good opportunity for all those individuals who don't have access to pension schemes such as self-employed or employees not covered by occupational pensions or nonresident Pakistanis to build their pension funds. It also provides a good opportunity to the corporate sector to shift from defined benefit to defined contribution by supplementing or replacing existing occupational retirement schemes with matching contributions to VPS for their employees.

VPS would enable a larger population to have pensions to supplement their incomes as they attain old age and additionally the presence of large amounts with the pension fund managers would be helpful in improving liquidity in capital markets as more funds will be available for investment as is the case internationally.

Little drops of water, little grains of sand,
Make the mighty ocean, and the pleasant land.
So the little minutes, humble though they be,
Make the mighty ages of eternity.