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Pension Reforms-
Time to adopt funded pension scheme

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Pakistan is one of the few countries left in emerging economies where the state has not been able to bring in necessary reforms in the Pension System for its public sector employees. There is realization now that the present defined benefit pension system (unfunded pension system) is getting unmanageable given its growing size. In Defined Benefit (DB) system, there are no underlying assets of pensions and it is only the government's commitment with its employees that they will be paid a certain amount of pension per month after retirement depending on their salary and grades during employment. This future liability is met through each year's revenues (mostly taxes) and it is part of the current expenditures of the government each year. In FY2020, total of PKR. 890 bn was paid in pension by federal government, four provinces and the Army, while this amount is budgeted to increase to PKR. 988 bn in FY2021. This now accounts for 22% of tax revenues. The combination of low growth in taxes and increasing size of pension liabilities, pension burden will become unmanageable if they continue with the existing unfunded pension system and delay the adoption of Defined Contribution Plan (funded pension system). In the funded Defined Contribution (DC) system, a certain percentage of basic salary is deducted each month and it gets invested in assets such as bonds or equities depending on the choice of funds selected by the pensioner himself/herself or his service providers such as the body of the government which collects these payments from them and who then invest these funds on their behalf.

Pension liabilities:

	FY2020	FY2021 (Budgeted)
	Rs. in billions	
Federal government	94	111
Army	327	359
Punjab	237	251
Sindh	125	145
Khyber Pakhtunkhwa	73	84
Baluchistan	34	38
Total	**890**	**988**

Among major emerging economies, Brazil brought in the necessary changes in its pension system in 2019, while India has adopted the DC system in 2004 and as of last year total assets under management in its national pension system were $45 billion with over 12 million subscribers' base. Presently, majority of the Latin American countries, most of Europe and majority of Asia have funded pension system.

Why it didn't happen in Pakistan so far?

Pakistan has looked at the possibility of moving to Defined Contribution (DC) system from Defined Benefit (DB) system about 15 years ago when Mr. Shaukat Aziz was Prime Minister during the days of General Pervez Mushraf rule. This was when India had moved to change its Pension System and the World Bank was encouraging its member countries to adopt the DC funded system. But nothing happened on this front as each successive governments in the country who came into power had their own set of priorities most of them struggling with serious economic challenges of slow economic growth and higher fiscal deficits, not to mention the very weak external account position the country had to live with during those years. While the economic challenges were pointing towards addressing the Pension System but none of those governments had the political will to go ahead with such bold reforms. Moving to DC system will have long term positive impact on the economy, however, government employees will also get exposed to the volatility of asset classes and they may not be able to pool in the necessary assets in their respective pension accounts by the time they get retired. In many countries, government employees were initially hesitant and rather fearful in adopting the DC system as they feared that it is an attempt to reduce the pension payout. However, this system is now in place all over the world

and the good thing is that it has benefited the government in terms of lower liabilities but also enabled government employees to decide proactively their asset allocation in the pension scheme so that they are able to have reasonable assets in their pension account by the time they get retired.

Can we hope it from PTI government?

Recently after the budget 2021 announcement, people have started talking about the growing burden of pensions on the government, without really discussing an options as to how to address this situation. There were even reports of government reducing the retirement age and cancelling the pension altogether for new employees or giving very less pension in the future. While in Pakistan monthly pension paid is much lower than the last drawn salary when they were drawing compared to world averages, however the vast number of government employees mostly at the lower scales have added to the problem. Most of the government departments are overstaffed with abundance of lower cadre jobs. They are hired at low salaries and many times political appointees are given jobs, not necessarily on need or merit basis. Each year they get increment in salary as announced for government employees and they are entitled for pension after retirement. This is how the government system is working which is adding more people on government jobs, paying out more salaries and thus accruing higher future pension liabilities. It has become an unmanageable situation and the sooner a way out is found it will be better for the country. Now what is needed is that the government has to review the situation and take the decision in the best interest of the country.

Follow how others have done it

We have plenty of examples how other countries have implemented the funded Pension Schemes during the past two decades which are relevant to us.

Following is the broader road map for its formation and implementation:

1. Principal decision by the cabinet to implement a defined contribution pension plan replacing the defined benefit plan for all government employees starting from a cut-off date of say January 1 or July 1, 2022.
2. Do the necessary legislation and pass it from the parliament.
3. Creation of a separate trust with suitable name such as Pakistan Pension System (PPS) or any other similar name. Putting in place the organization, its infrastructure in terms of employees, technology and office places.
4. Creation of national database of pensioners, consisting of all employees of Federal/Provincial Governments and military personnel who avail pension. Civilian employees'data is with Accountant General Pakistan Revenue office and Army's data is with Controller Military Accounts. The creation of this national database could be time consuming as it will require putting in place the right infrastructure in terms of IT hardware and recruitment of staff before all the data is available on the system and linked to PPS, Banks and fund managers.
5. Appointment of fund managers (such as asset management companies managing voluntary pension schemes) by PPS who will invest the money in Dedicated Pension Funds managed by them for pensions. Most likely, AMCs will form new dedicated PPS funds with their own brands who will be authorized to receive and invest money from PPS.
6. Appointment of custodian and trustee who will hold the assets and manage the operations between PPS and fund managers.
7. Appointment of annuity providers such as insurance companies.

How it will work when implemented

After the adoption of new system, all new employees will be rolled in the Defined Contribution Plan instead of the Defined Benefit Plan. However, it will take much longer to shift completely to DC from DB and perhaps it will take next two decades to complete this process. In some countries, it has taken even longer to shift to a fully funded system. Old employees who are in defined benefit plan will continue to be in the old system till they are gradually moved to the new funded plan. This will require some time and the process will be executed gradually per department wise or scale wise or the year of joining.The transition from DB to DC is a long process,

where after the introduction of DC both the systems will run parallel till all DB based pensions are transferred to the new system. The transition could be faster provided the government has the means to do so as it will involve transferring all the future liabilities to fully funded assets. Usually government fiscal constraints does not allow this to happen. During this period government will be paying the old employees per their existing defined benefit system. An actuarial estimate can be made based on existing government employees, their existing salaries and their years to retirement. We know that existing yearly payment on pension is close to around Rs.1 trillion, which suggest that the entire pension liability could be roughly around of Rs.10 trillion. A mechanism for shifting the entire unfunded liabilities into funded assets could be worked on new yearly contribution from new employees and gradual conversion of old employees in DB system into the new system. Given the very high size of unfunded liabilities, it will be gradual conversion spread over the next 10 years or so and in between if the government fiscal position allows it may expedite the conversion into funded scheme.

Presently, payroll and retirement (both DB pension and provident fund) data of public sector employees is maintained by the Account General Pakistan Revenue (AGPR) office while for the military it is handled by Controller Military Accounts. Once PPS is formed, there will be gradual shift of this responsibility from AGPR and CMA which will maintain only the data of old employees who are already in DB system. However, a new system of defined contribution plan will have to be incorporated in the system. Most significantly, liabilities under defined benefit plan will have to be worked out and updated till the employees are moved to the defined contribution plan. Profits on the balances in old benefit plan will continue to be added as per the existing formula till these balances are shifted to defined contribution plan.

Pension funds will earn market based returns

It has been observed that during the initial years the rate of return on funded pension schemes have been relatively lower due to higher operating costs or underdeveloped small size domestic financial markets.In some years, lower returns were due to very high volatility and steep fall in the financial markets such as the financial crisis of 2008 and very low returns on Government Securities due to very low interest rates in many countries. The returns on funded pension will be the function of appropriate asset allocation in debt and equities and overall performance of these financial markets. Typical pension funds have these three asset classes; government fixed income securities, private sector bonds and equities. These funds are then categorized as Conservative, Balanced and Aggressive depending on asset class in their portfolios. Given the long term nature of pension funds, they usually have allocation in equities ranging between 25%-75% depending on the age of pensioner and his/her preferences, while those closer to retirement age are mostly invested in fixed income Government Securities. Despite higher volatility, Pakistani equities have delivered one of the better long term cumulative returns compared to other asset classes and therefore exposure in equities should help in building higher savings during their job tenures.

Good for the economy and market

Changing to DC will have two fold impact, first it will reduce pension burden on government, and second it will create the necessary fund pool to invest in the capital markets consisting of bonds and equity. All over the world, pension funds have the biggest holdings in equities and debt instruments of any country. Countries having bigger pension funds have relatively stable and vibrant capital market as they provide the necessary liquidity and depth thus leading to reduced market volatility and better price discovery. Pakistan has been facing a serious challenge in mobilizing domestic savings and pension reforms will help in generating higher domestic liquidity for long term investment needs of the country.

Wasim Akram
National Investment Trust Limited

March 24th, 2020 marked a significant milestone in the development of the capital markets of Pakistan. It was the day that the first ever ETFs started trading on PSX. Although the sentiment was clouded largely by the fears of COVID-19 and its larger implications - both long term and short term, the launching of ETFs in Pakistan is a significant development nonetheless. Why it took so long for such a useful, tried and tested investment product, which has its very own and unique benefits, to actually enter the financial market in Pakistan is a different topic of discussion.

However, it is pertinent to highlight why ETFs are a much needed investment product for Pakistan, and how they have the capacity to revive interest in investment products and attract new investments even from people who do not invest in the more traditional investment products. One of the main qualities of ETFs is their hybrid nature. They are mutual funds, with all the benefits of diversification and a well set-out strategy, with the major additional benefit of being traded in the stock market. ETFs therefore, have the ability to attract a far wider investor base as it is attractive for traditional stock market investors and also those more inclined towards investment in mutual funds. To elaborate further, while a more risk averse investor would like to diversify his risk through investment in mutual funds, a more active investor is able to take advantage of the ups and downs of the stock market through trading actively in ETFs. Thus in both these cases, ETFs provide an attractive, and much needed, investment avenue.

There is a fear generally among market participants that ETFs, being similar to closed-end funds in that they trade in the stock market, may face a situation similar to closed-end funds where these funds used to trade at significant discounts to their NAVs. Such discounts used to be as high as 20% or even more, as compared to their NAVs. However, ETFs tend to take care of this very important issue when compared to closed-end funds; the redemption option available to Authorized Participants. While limited to Authorized Participants only, the redemption option improves significantly on the concept of closed-end funds in that there would always be a market participant who would have an incentive to close any gaps that exists between the market price of the ETF and its NAV, through buying the fund at a discount and having it redeemed. So the market price would always be close to NAV under normal circumstances.

While the structural advantages of ETFs are obvious as described above, as investment managers, our main focus is to come up with attractive strategies that would make this product a more desirable and profitable investment option for investors. The concept of NIT Pakistan Gateway ETF (NITG-ETF) is something that we believe will be an attractive investment option for all investors in the stock market, be it retail or institutional or foreign investors. An equities ETF, NITG-ETF tracks the NIT Pakistan Gateway Index (NITPGI), which gives investors exposure to the top 50% of the KSE-100 companies weighted by free-float market capitalization at all times, subject to certain liquidity criteria. The current basket of NITG-ETF consists of the most liquid 12 stocks, which form the top 50% in terms of the free-float market capitalization of the KSE-100 index. This not only gives investors a decent exposure to the main stock market index, the KSE-100, it also represents a diversified exposure to an array of top tier stocks and sectors of the Pakistan stock market.

While this is among the first ETFs and many more are going to follow, NITG-ETF will not only be counted among the pioneering ETFs in Pakistan, the concept of the fund will also prove to be attractive to a cross-section of investors looking to take exposure in the Pakistan stock market and the growth story of Pakistan in general. Thus we look forward to NITG-ETF truly proving itself to be a gateway to Pakistan from a stock market perspective.

T. U. Dawood
786 Investments Limited

When I launched 786 Investments Ltd. in 2003, then known as Dawood Capital Management Ltd., from the start, the plan was to build a legacy company. After a five-year honeymoon period, the global financial crisis of 2008 made clear that intent was meaningless without not just solid foundations, but built-in business resilience, sustainability checks and balances, as well as ensuring that while obstacles, market distress and unpredictable disrupters can arise at any moment, at all times, we could safeguard people and assets while maintaining continuous business operations. As a publicly listed company we had the added responsibility of protecting and managing shareholders' interests in the company.

In 2008, when the equity funds were suspended due to the suspension of the stock exchange, we had an immediate massive run of over 90% in our Money Market Fund in redemptions. The SECP immediately suspended redemptions for all funds till they were able to meet all redemptions. As a relatively young company, just 5 years old, we had no experience with such a crisis, nor could we find solid precedent for what to do, but knew that our clients' money was their money, and they had a right to it at all times. Our Board made the decision that we did not want to give a haircut to our investors. We had to be resourceful, think outside the box and come up with a solution. I thought back to an old black and white movie I loved, "It's a Wonderful Life" (1939) starring Jimmy Stewart. The way that financial institution saved itself was calling upon friends in the community to be patient and flexible in other ways of claiming their funds. We had some liquidity and we had some term finance certificates so we called up our bigger investors and asked them if they would take equivalent amounts of the redemption they required as instrument instead. They graciously agreed. With the wonderful support of the business community and our clients, we were able to fulfill all redemptions, without any haircuts and take all losses ourselves as an asset management company. But then, what? How do we begin again and how to build this time stronger.

As the 2008 crisis was a crippling one, it was a slow journey upward, and there have been numerous obstacles, disruptors and even technological changes along with way, but the most amazing thing was how much these prepared us to be resilient for COVID-19, so that we could embrace change and stress-test our resilience very mindfully.

So, in early 2020, when many Western countries began lockdowns, we started contingency plans, strengthened our back-up office, virtual office drills, and so forth. The goal was to safeguard our people - our greatest assets - as well as our clients and their monetary assets, while maintaining continuous business operations. Once the government announced lockdown, it was clear daily wage workers, restaurants, malls, etc. would lose their income, but that was only the start of an economic decline. One thing we were now experts at 786 Investments Ltd. was economic declines. We were determined to be braced and ride the wave of this one, rather than be drowned by it.

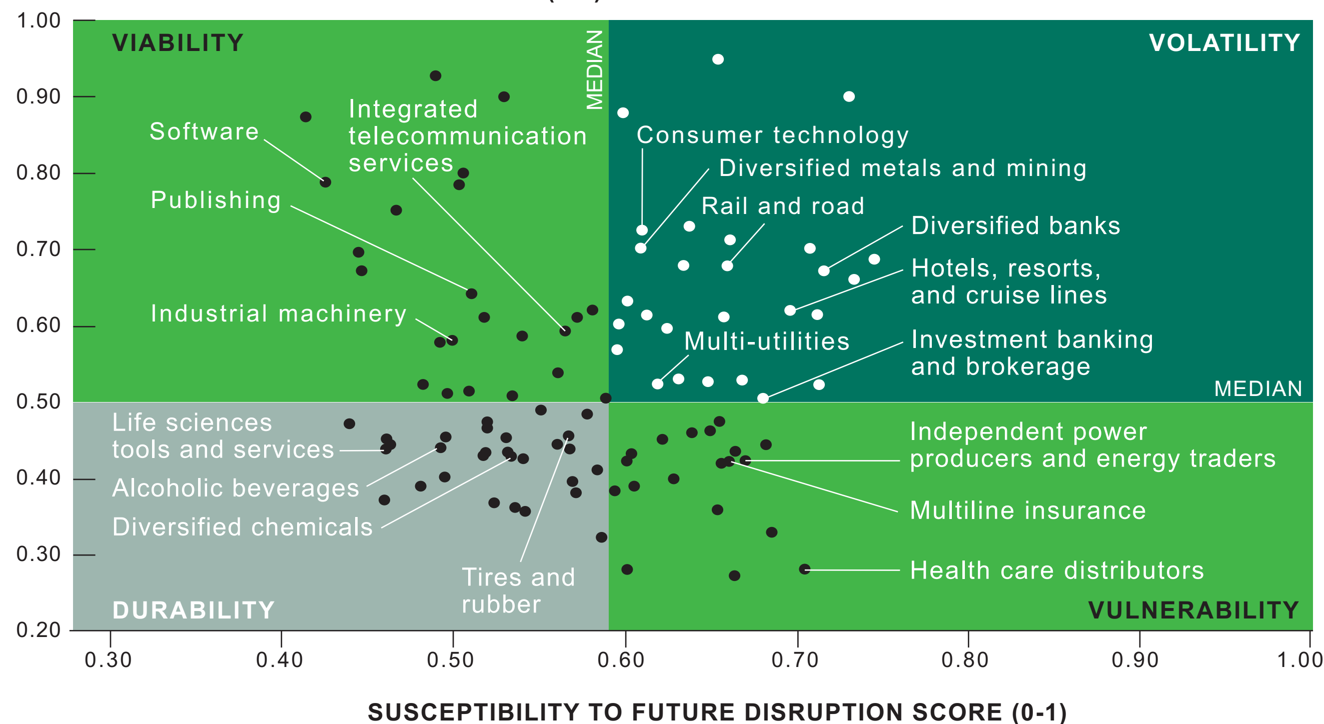
Mindful business resilience strategy can mitigate the impacts of a disruption and facilitate your company to continue to function or to return to normal more quickly, and ideally improve overall performance. So many people have asked me to share my top 5 tips for building a resilient business, so here goes:

Tip #1: Understand Disruption Inside and Out

Accenture developed a Disruptability Index to help business leaders better understand industry disruption, which positioned 20 industry sectors - and 98 segments within those sectors - against those a measure of an industry's current level of disruption as well as its susceptibility to future disruption. According to a Harvard Business Review article, "for the former, [they] examined the presence and market penetration of disruptor companies; we also considered incumbents' financial performance. For the latter, [they] measured incumbents' operational efficiency, commitment to innovation, and defenses against attack. They then used the median scores as dividing points to highlight four distinct states of disruption: durability, vulnerability, volatility and viability."

The Four States of Disruption

How susceptible is your industry?



It's not a question of if our industry will be disrupted, but when and how often! Studying about and mastering disruption is a must these days.

Tip #2: Welcome Disruption

Whether it is a market crisis, a technological development or a pandemic, ultimately disruptions are going to happen so embrace them, be vigilant for them and welcome them as opportunities for upgrading your model and at all times, putting your customer needs first. I remembered well Shahid Ghaffar, who was MD of NIT, which had a 10% stake in 786 Investments Ltd., once telling me, "If you put your customers first, everything else will fall into place." So, we ensured that we wrote to each and every investor prior to any government enforced lockdowns to 1) share COVID-19 health tips and safety guidelines; 2) how to safely interact with us during this

period; 3) to let them know we were on top of things; and 4) to inform them that we cared about them, their health and safety and the protection of their assets. We also shared with them how we were protecting our own team members, recognizing that purpose-driven, good citizen businesses are a big priority for clients in 2020.

Tip #3: Cut Out The Fat

While many resilience strategies talk about product diversification and spreading risk across products, markets, services, and investments, we've found a lean, streamlined approach can be more powerful, as you focus your energy and talent in what you do best. Tightening your ship not only reduces costs, but costs out a lot of fat. In this age of technology, COVID-19 has taught us how little needs to be done in person and how much more work can be achieved, if you are not wasting time with commute, tea breaks, and so forth. So, not only are our team meetings on Zoom, but so are our board meetings, client meetings, audit meetings, discussions with regulators, and so forth. However, cutting out the fat refers to much more than just video conferencing. Cash flow, HR, communications, product offerings, all must be examined from a lens of adaptability and redundancy.

Tip #4: Gear Your Team for Disruption

It goes without saying that it's not enough for senior management or C-level to be trained in disruption, your entire company should be mentally aware and prepared. That's why we had virtual office drills in the two weeks prior to lockdown. Disruption is even more significant in Pakistan as we have such a young population, who are entering the workforce having grown up more connected than any previous generation. Their expectations and demands with regard to speed of communication and ease of access to information can be overwhelming to and put a lot of pressure on traditional enterprises to adopt a more digital culture. For example, if a junior team member had a complaint ten years back, it would go through proper chains of review. Now, it comes often as a whatsapp group message demanding an immediate response. So, build flexibility, openness and evolution into your culture and then when external disruptions come, you will also be geared and your team more prepared for such changes, or at least more prepared than a company with a rigid corporate culture.

Tip #5: Ride the Wave, Rather Than Fight It

Several companies and colleagues in the business community viewed the pandemic and lockdowns as quick, one offs, and were eager to get back to day to day. We didn't. We remained vigilant, alert and eager to understand what was happen holistically, realizing there was a larger shift taking place, not only in how business would be done, but in how day to day life would be run. Jahangir Siddiqui once shared with me how one of the keys to his success was vigilance and quick exits. So, rather than fighting the growing signs of COVID-19 being a game changer, I started observing its impact on our corporate community, both in terms of clients as well as in terms of team members, regulators, colleagues, etc. We decided to make each decision one step at a time, being calm and open, prepared for more unexpected, not denying that change was happening. This choice to ride the wave, rather than fight it, was one of the best decisions we made, as not only did it ensure no hasty mistakes at the time, but it helped protect the mental health of our team and clients, which is vital to a long-term strategy for any company.