MERCER

Pension Design and Marketing

The Annuity Malaysia Experience

By Zainal Abidin Mohd. Kassim, FIA

The move from Defined Benefit Plan (DB) to Defined Contribution Plan (DC) has exacerbated the task of the masses, that of seeking a comfortable income in retirement. Retirement plans in Asia have traditionally provided a lump sum at retirement while conventional pension plans are usually limited to the civil servants. While the employer under the DB schemes carries the investment risk prior to retirement, the recent volatility of returns has made DC scheme members worried. Upon attaining retirement age the employees would then be faced with the task of ensuring that the lump sum they receive would last their remaining life time.

In Malaysia, employer sponsored retirement plans are not prevalent due to the presence of the Employees Provident Fund (the EPF), a RM200 billion DC behemoth to which all private sector employees are required to contribute to. The funded employer sponsored retirement plans in Malaysia that prevail, serves as top up scheme to the EPF. These schemes were not spared from the fallout of the Asian Financial Crisis of 1997. This has led to many a private retirement scheme being wound up and its accrued benefits transferred to the EPF. Employers simply wanted to rid itself of having to carry the investment risk associated with funded DB Schemes while employees under DC schemes were tired of seeing negative returns on their balances.

In an effort to allow EPF members to diversify their EPF investments, the EPF introduced the EPF Annuity Schemes (the SAKK and the SATK) in the year 2000. The SAKK, which was the EPF Conventional annuity scheme (a separate Islamic annuity scheme call the SATK was also provided in parallel) allowed an EPF contributor to withdraw money from his EPF account to purchase a participating single premium deferred annuity which commence to be paid at the age of 55. This product was provided by a consortium of insurance companies (collectively called Konsortium Anuiti Malaysia) and was marketed by their agents.

It is instructive to examine in some detail the features of this annuity product, what contributed to its success in accumulating a large pool of investments for the insurance companies, how the product was greatly misunderstood by the Consumers Association, the Trade Unions and various other ‘guardians’ of the EPF and what finally led to its demise.

The SAKK was a simple scheme (see Appendix 1 for a brief description of its features). For a given premium the purchaser would be entitled to a single life deferred annuity which would increase with bonus whilst in deferment and then also when in payment for the rest of his life. With the introduction of the SAKK, for the first time then, an EPF member who purchase the annuity was able to visualise actually how much income he could expect to receive at his retirement.

Why was this an important development? While the EPF has been successful in increasing the savings of its contributors towards retirement, this amount has been put under strain by various early withdrawal schemes. These early withdrawal schemes were basically ‘Life Cycle’ benefits. As examples, the EPF provides a facility for Members to withdraw from their EPF account to assist in the purchase of a house, for their children’s education and for a while, for the purchase of a computer. These withdrawal schemes have eroded the amount of lump sum that would be available to the member at retirement. What more, a recent survey conducted by the EPF revealed that over 70% of its members would have exhausted their EPF moneys within three year of withdrawing their lump sum on retirement at age 55.

What were the incentives provided under the Annuity Schemes? One important incentive provided was already in place even before the annuity scheme was introduced. That was that annuity payments made from locally incorporated life insurance companies were tax free in the hands of the annuitant. Another incentive introduced, but only after the introduction of the scheme, was that for tax purposes a purchaser of the annuity was able to claim tax relief on the premium paid (subject to a RM1,000 per annum limit). For some, this amounted to double tax relief as their contributions to the EPF had already enjoyed tax exemption. There was no exemption given to the investments of annuity funds which is taxed at 8%, similar to other insurance funds.

What were the challenges to the Konsortium in coming up with this scheme? It took nearly five years for the Scheme to move from conception to introduction. Among the annuity designs which were initially considered included:

a) An immediate annuity to be purchased only at retirement

b) A deferred annuity purchased at age 55 (the normal retirement age) but payable only from age 60 or at later ages.

In the end a single premium participating deferred annuity was accepted by all parties. The single premium concept was forced on the Konsortium as the EPF could not administratively handle regular premium deductions from members EPF accounts (e.g. what would happen if there were insufficient funds in the EPF account).

Given that these annuity contracts were long term contracts, the Konsortium pricing strategy was to offer a participating product. These policies were priced to pay a compound bonus in the form of bonus additions to the annuity payable. The projected bonus was 2% p.a. A 2% p.a. bonus effectively provided a 2% margin on the pricing assumption to buffer the company against interest rate risk and longevity risk. Nonetheless, the underlying guaranteed yield to the annuitants was between 4% to 5% p.a. (the EPF by contrast provides only a 2½% p.a. guarantee on its dividend rate). Being single premium in nature, this underlying guarantee could be partly matched by purchasing bonds at the date of sale of the annuity. Under the existing Insurance Regulations these policies also do not require much additional shareholders equity.

Appendix 2a provides a sample of the rates on offer under the SAKK while Appendix 2b provides a sample illustration of the expected ‘growth’ of the annuity over time. This illustration was used by the insurance companies’ agents to sell the annuity to EPF members. The exchange rate is RM3.80 to US$1.

Within the period of eight to nine months doing which the product was sold, over RM4 billion was collected from over 200,000 EPF members under both the SAKK and SATK. This was indeed a significant amount, all the more so in light of the constant negative press that these products had to face.

What were the objections made against the annuity scheme?

i) That insurance company was profiting excessively from this product. The argument follows that the annuity scheme should not be given to the private sector to run but should be run by the EPF itself.

ii) That it represents 'a bad deal' to the EPF members. Members can lose their capital.

iii) That some insurance agents were misselling the product.

Let's consider the objections one by one:

i) That it profits the insurance Company excessively.

The insurance regulations in Malaysia requires that funds derived from this product be segregated from the insurance companies other insurance products. Distribution of surplus between annuitants and the Company are strictly controlled. The bigger the insurance fund the smaller is the proportionate share of surplus due to shareholders. While profits are controlled, losses are borne entirely by the shareholders. Thus, for the risks that the insurance company takes it is entitled to some profits.

How much profit, that is debatable. Certainly the insurance companies which participated in the scheme were unhappy with the restrictions placed on their share of the surplus arising from this product.

ii) A bad deal for the EPF Members?

As mentioned above the annuity product was priced on the basis that the insurance company would guarantee that the premiums invested would earn between 4 to 5% p.a. (this would need to be taken in the context that the inflation rate in Malaysia has averaged 2 to 3 % p.a. in recent years). At the time of the introduction of SAKK the EPF was providing a 6.8% dividend to its Members (its most recent declaration was 4.25% for the year 2002). If the insurance companies were to achieve its pricing target return (of between 6 to 7.5% p.a.) it would be able to provide an annual bonus of an increase of 2% p.a. compound on the base deferred annuity. Assuming that this is achieved, the return to the EPF member is determined by his longevity as the following table would show (for a male annuitant)

SAKK Rate of Return for Males

Survival to Age	Entrant Age 35 (%)	Entrant Age 45 (%)	Entrant Age 55 (%)
100	7.6	7.8	8.0
95	7.5	7.7	7.8
90	7.3	7.5	7.5
85	7.1	7.2	7.0
80	6.9	6.8	6.1
75	6.4	6.1	4.7
70	5.7	5.0	1.8
65	4.5	2.9	-4.6

The table shows that the longer the annuitant lives the higher the return on his investment. This is to be expected.

Comparisons were drawn between the (only) 2% p.a. bonus projected by the Konsortium and the EPF dividend rate of 6.8%. Obviously this was misleading as the 2% bonus is in the form of an annuity payable for life while dividend is only paid once on the outstanding capital.

There ware incessant criticism of the annuity product. Many individuals (some with impressive credentials) made statements about how the product was not a good deal to the purchaser.

Comparisons were made in the press between the annuity benefit and money left to accumulate in the EPF. An example of this comparison is given below:

Age at Purchase (Male)	Life Expectancy (Male)	Sum invested in Annuity or EPF (RM)	Rate of Return (%)		Annual income (RM)	
			Annuity	EPF	Annuity	EPF
20	75	6,150	3.2	6.7	1,200	3,987
30	76	6,775	4.0	6.7	1,200	2,296
40	76	8,993	4.5	6.7	1,200	1,594
50	77	14,724	4.3	6.7	1,200	1,364
55	78	19,152	3.9	6.7	1,200	1,283

What was wrong with the comparison? For one, it assumes that the EPF dividend rate would remain the same indefinitely. Given that the EPF dividend rate has since gradually dropped to 4.25%, this assumption is clearly not realistic. Secondly it assumes that the Member would die once he ‘hits’ his life expectancy. This is clearly inappropriate as the annuity itself is to protect against longevity. It also assumes that the annuity would not accrue any bonuses (bonuses are not guaranteed, it could be higher or lower than illustrated, but once declared its guaranteed payable for life).

It is also instructive to note that nearly all comparisons that were made in the press assumed that the members could live off the income on his capital. On death this capital would be passed on to the dependents while the annuity scheme would not provide any ‘residual’ amount.

With hindsight the Konsortium could have made a greater effort to counter the negative statements made on the product. On reason why they held back was the political sensitivity of the product as the commotion had drawn in the country’s top ministers, including at the later stage, the Prime Minister himself.

iii) What about Agents “misselling”

How widespread was the misselling? It is pertinent to note that while misselling was reported in the press none (that I know of) actually came through as formal complaints to the Konsortium.

The success of the SAKK took even the insurance companies by surprise. They were sceptical at first that an annuity product could be a success in Malaysia. Annuities were available from a handful of insurance companies but they have never been successful as a product. Prior to the SAKK there were probably less than a dozen inforce annuity policies in the whole of Malaysia.

But a success it was. What were the contributory factors?

a) It was ‘painless’ to the Members. The money was paid directly from their EPF accounts to the insurance company of choice.

b) It paid a nice commission to the agents. Although the commission was only 2% to 3½% of premium, the average premium size was RM 20,000. Over 30,000 agents were involved in selling this product.

c) Purchasers of the annuity saw it as an opportunity to lock in on an income stream.

Many stories emanated from agents as to why the annuity was a success. Among them, working wives bought them for themselves to ensure that their husband would not be tempted by the cash lump sum when the wife retires. Members near retirement bought them so as to prevent their children from borrowing these moneys when they retire.

Surprisingly, people were in fact ready to surrender the flexibility of cash for the certainty of a regular income. Over 50% of the purchasers of the product were below the age of 35. Only a few actually bought the product at age 55.

Would the scheme work now in the current economic environment?

The guarantees that the insurance companies provided (a minimum interest of 4% to 5% p.a. on the amount invested, the annuity payable for life) are valuable. These guarantees were being provided at minimal cost to the annuitants primarily because the current (insurance) reserving basis do not require a risk premium (additional capital from shareholder to back the annuity). However, the global move towards Risk Based Capital for financial institutions would mean that these annuity products would soon become capital intensive and thus make them less affordable to the public due to the need to price in the cost of capital.

The risk issue is determined also by whether the insurance companies can find suitable investments to ‘match’ their liabilities. In Malaysia the answer is not yet. While bonds are available, they are not long enough for matching the liability. Certainly this is a factor which caused the insurance companies to decide recently not to pursue the reintroduction of the annuity scheme. It was alright to write a small amount of the business (relative to their other insurance products) but another to make it their main income earner. The risks were too high. The drop in interest rates recently (bonds yields have dropped by nearly 200 basis points) also meant that annuities priced now will be more costly and are likely to face more criticism from those in the public who do not understand how these products work.

So what of the future? The need for affordable annuities is even more crucial now then before with the worldwide move from Defined Benefit to Defined Contribution pension plans and even more critical in certain countries where members had to move from a pension plan to a lump sum defined contribution plan. Insurance companies in Asia may not be in a position to offer this product, as:

i) There may be no suitable investments with which it could hedge the investment risk it is taking on. The bond market in Asia is not well developed. The duration of available bonds is also not long enough.

ii) The cost of providing the underlying guarantees that an annuity provides (interest guarantee, longevity guarantee) would become expensive as Risk Based Capital is gradually introduced in Asia.

iii) The level of understanding of how annuity works is low among the general public. The criticisms from consumer associations as to the ‘high cost’ of these products reflect badly on the insurance industry as a whole.

What is the Solution?

If annuities were to be made affordable it is probably necessary to establish an entity that specialises in this product. A National Annuity Corporation. This would of necessity be government backed so as to eliminate the risk premium mentioned earlier which has been identified as a contributor to making the annuity product less affordable. It is also necessary to ensure that the public understands the concept of annuity. One of the criticisms of the Malaysian experiment was that the insurance companies did not do enough to educate the public on the concept of the annuity product they were selling.

The need for income for life rather than just a lump sum at retirement is universally accepted. The current low interest environment is a threat to retirees. It would now be impossible to just live off the income on your capital. At retirement the individual investor would also not be able to tap the higher returns that professional asset managers are able to. Neither will he be able to hedge the risk of his longevity. Unless the person is rich, it is grossly inefficient not to utilise the bulk of one’s capital in one’s lifetime. Annuities are therefore a must have product. But would the individual voluntarily purchase one? The Malaysian experience would seem to indicate yes, but under certain conditions.

In the final analysis it may be necessary for the government to mandate that not all retirement benefits be taken as cash, an annuity must also from part of the retirement package. To make annuity more affordable, it may be necessary to require that annuities be purchased prior to retirement (i.e. a deferred annuity). This is controversial but should be considered. By purchasing the annuity prior to retirement the selection premium can be reduced or even eliminated. The retirement money can also be tapped before it is used for other purposes. Furthermore, it was observed that not many annuities were purchased among those EPF members who are age 50 and above. This is partly because the amount remaining in their account was low (due to prior withdrawals for one) and the fact that the closer one is to retirement the more alluring is a lump sum as compared to an annuity.

An insurance company would need to manage its risks prudently as it carries with it the savings of other policyholders, not just annuitants. The trend now among insurance companies worldwide is to pass the risk where possible back to the policyholder. Witness the trend to investment linked policies worldwide. Even where longevity is involved, insurance companies try to limit the risk by offering ‘term’ annuities rather than ‘whole life’ annuities. Where insurance companies are willing to take on the interest and longevity risk, the policyholder would have to be prepared to pay for this service. Thus, in the near future private sector annuities are likely to be more expensive. What the private sector is good at however, is providing choice.

Like everything else in life, the best solution is probably a compromise:

i) A basic inflation linked single life annuity could be made available for purchase from a National Annuity Corporation fully backed by the government. The maximum annuity available from the corporation would be limited to say 80% of National Average Earnings in the year of purchase. The pricing of this annuity would be driven by appropriate commercial assumptions but will not include the cost of capital.

   This would provide affordable annuities to the masses.

ii) The development of a private sector market for other annuities. The private sector could offer top ups to the basic annuity, joint life annuities, term annuities etc.

Such a partnership would also ensure that the government would not be creating another public sector behemoth and would stimulate the development of private sector annuities. The growth of an annuity market would also stimulate the growth of a bond market, especially at the long end of the curve. This is a source of finance governments should be happy to tap, if not the private sector.

One other important role for the private sector is in its distribution power. Its agents could be deployed to sell both the basic annuity and the top up annuity. The Malaysia experience underlines the power of insurance agents in distributing an annuity product.

What eventually caused the termination of the EPF annuity product? The case for and against the annuity product was finally decided by the Prime Minister of Malaysia. He ordered the indefinite suspension of sale of the annuity to EPF members.

That event underlines another important lesson from the Malaysian experiment. That a product as important as the national annuity scheme needs the full backing of the government to ensure its survival.

MERCER

Suite 17.02 Kenanga International
Jalan Sultan Ismail
50250 Kuala Lumpur
Malaysia
Tel: 60 3 2161 0433   Fax: 60 3 2161 3595
Zainal.Kassim@mercer.com

30th May 2003

Appendix 1

Benefit Provided under the SAKK

Each unit purchased would provide the following benefits:

- A single life annuity of RM1,200 per year at purchase date plus bonus addition to the base annuity projected at 2% per annum compound during deferment and continuing after vesting. Vesting age is age 55.

- The annuity is guaranteed for ten years from vesting age.

- On death prior to vesting, a ten years annuity certain commences immediately.

- A TPD benefit prior to vesting of an immediate vesting of the annuity for a minimum of ten years from date of disablement.

Appendix 2(a)

Premium Contribution Rates

Age	Male (RM)	Female (RM)
25	6,462	7,226
35	7,087	7,867
45	11,454	12,731
55	19,152	21,288
65	16,217	18,025

Appendix 2(b)

Sell Illustration for Skim Annuiti Konvensional KWSP (SAKK)
Participating Deferred Annuity Plan with Guaranteed Annuity Payment Period

Annuitants Details:

Entry Age (Nearest Birthday) : 35

Date of Birth : 3 March 1969

Sex : M

Single Premium (RM) : 7,087

Annual Amount : 1,200

Monthly Annuity Amount : 100

Deferment Period (Yrs) : 20

Plan Description : This is a participating Deferred Annuity policy. The basic annuity payments are GUARANTEED to be payable monthly starting from age 55 birthday of the annuitant. This policy participates in the surplus of the Company's Annuity Fund.

End of Policy Year	Annuitant's Age	Guaranteed (A)		Not Guaranteed (B)		Total Benefits – (A) + (B)	
		Basic Annuity Payment	Surrender Value	Bonus Annuity Payment	Bonus Surrender Value	Total Annuity Payment	Total Surrender Value
		(1)	(2)	(3)	(4)	(5)=(1)+(3)	(6)=(2)+(4)
1	36	-	6,855	-	-	-	6,855
2	37	-	7,129	-	-	-	7,129
3	38	-	7,414	-	-	-	7,414
4	39	-	7,711	-	-	-	7,711
5	40	-	8,019	-	-	-	8,019
6	41	-	8,340	-	-	-	8,340
7	42	-	8,673	-	-	-	8,673
8	43	-	9,020	-	-	-	9,020
9	44	-	9,380	-	-	-	9,380
10	45	-	9,756	-	-	-	9,756
11	46	-	10,147	-	-	-	10,147
12	47	-	10,552	-	-	-	10,552
13	48	-	10,974	-	-	-	10,974
14	49	-	11,414	-	-	-	11,414
15	50	-	11,870	-	-	-	11,870
16	51	-	12,345	-	-	-	12,345
17	52	-	12,839	-	-	-	12,839
18	53	-	13,352	-	-	-	13,352
19	54	-	13,886	-	-	-	13,886
20	55	1,200	9,362	583	4,549	1,783	13,911
21	56	1,200	8,652	619	4,461	1,819	13,113
22	57	1,200	7,899	655	4,313	1,855	12,212
23	58	1,200	7,101	692	4,096	1,892	11,197
24	59	1,200	6,255	730	3,806	1,930	10,061
25	60	1,200	5,358	769	3,432	1,969	8,790
26	61	1,200	4,408	808	2,968	2,008	7,376
27	62	1,200	3,400	848	2,403	2,048	5,803
28	63	1,200	2,332	889	1,728	2,089	4,060
29	64	1,200	1,200	931	931	2,131	2,131
30	65	1,200	-	974	-	2,174	-
35	70	1,200	-	1,200	-	2,400	-
40	75	1,200	-	1,450	-	2,650	-
45	80	1,200	-	1,725	-	2,925	-
50	85	1,200	-	2,030	-	3,230	-
55	90	1,200	-	2,366	-	3,566	-
60	95	1,200	-	2,737	-	3,937	-
65	100	1,200	-	3,147	-	4,347	-