

**EPF:
A NOTE ON KEY ISSUES
& PROPOSALS**

by

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A Market & Longevity Risks

1. EPF's existing arrangement for the investment and pooling of risk offers no protection to a retiring contributor against market or longevity risks. Taking the case of market risk,
 - EPF's contributors are of various age groups,
 - the risk-bearing capacity of the young (as measured by volatility) is higher than that of the older group,
 - but EPF's investment programme (with respect to asset allocation) makes no distinction between each age group,
 - therefore, the young end up with an investment programme which bears too little risk (that is they are under-invested in equities) and the old with too much risk,
 - this anomaly has to be rectified.

2. Market risk with respect to a contributor's retirement funds can be addressed by investing it in less volatile assets as he nears his retirement age. But the retiree still faces the problem of smoothing his income or consumption after his retirement.
 - a retiree faces both market and longevity risk,
 - a well-developed market in annuity products can address these risks, but only up to a point,
 - and the market in annuity products is still extremely under-developed because of over-regulation and over-protection of the insurance and fund management industries.

B Under-saving for Retirement & Health Insurance Cover

1. EPF started off as a retirement fund.
2. Today contributors are also allowed to withdraw up to 40% of their accumulated savings for housing, education and health.
3. With the increase in the withdrawals for these purposes and declining returns, there may be a shortage of savings for financing one's retirement living.
4. There is therefore, a case for an increase in the contribution rate, or an increase in the retirement age or a restriction on withdrawals.
5. The solution is not to curb withdrawals for the big ticket spendings.
6. A contributor saves during this working life and dissaves in retirement.
7. He will experience volatility in his consumption (e.g. on health) and investment (e.g. on house purchase and children's education).
8. An optimal retirement plan must smooth his consumption over his life cycle and facilitate lumpy investments, if necessary, by letting him draw on his accumulated fund or borrow against his future retirement contributions so that he can minimize the incidence of over-saving and inequities.
9. With the increasing privatization of the health industry and increasing life span, there is also a call for an insurance cover to meet medical expenses especially in old age.
10. A compulsory cover through EPF may be the best answer with deductibles to minimize the problems of adverse selection and moral hazard.

C Need for Separate Management of Funds in Different Accounts & of Different Age Groups

1. There is a strong case for a member's retirement fund (which is held in EPF's Account One) to be managed differently from a member's savings balances (held in Accounts Two and Three) and earmarked for housing, education and health.
2. The retirement fund in Account One is a long-term fund whereas the multi-purpose savings fund in the other two accounts is a short-term or a medium-term fund.
3. Accordingly, the asset allocation criteria for the two funds should be different. However, no distinction is made in the management of the two funds presently.
4. Given the difference in their intended use, I believe that the asset allocation decisions for the two funds has to be different.
5. A higher proportion of the retirement fund has to be invested in equities.
6. The multi-purpose funds has to be invested in bonds and money market instruments.

D The Adverse Impact on EPF's Behavior of its Inappropriate Policies in Accounting, Performance Measurement & Dividend Payment

1. EPF's equity investments are not being marked-to-market.
2. Further, EPF has not been required to invest on a portfolio basis.

3. There has been no benchmarking or evaluation of the performance of EPF's investment portfolio against the appropriate market benchmark.
4. Instead, EPF's performance has been evaluated in relation to an absolute target return that is not related to how the market has performed or trends in interest rates.
5. Further, the dividends declared are based on the income earned and on realized gains or losses and not on unrealized gains or losses.
6. On account of the above considerations, EPF has and can continue to suffer from the following weaknesses:-
 - EPF is and can continue to be under-invested in equities on account of a possible bias towards capital preservation (although equity is the best asset class for a long-term pension fund)
 - EPF has and will continue to treat its contributors differently because of differences in the timing of their withdrawals (with the existing rules favouring the more wealthy or savvy contributors).
 - EPF has or will have a tendency to sell its winners (to book the realized gains so that dividends can be declared) and keep its losers. This can in the long run lead to a deterioration in the quality of its investment portfolio and
 - EPF is or may be vulnerable to undesirable external influences in the decision it makes and hence to weak governance practices.
7. EPF does attempt to operate as a portfolio investor. But it has faced a serious constraint in investing in marketable securities and on a portfolio basis:-
 - as domestic financial markets are under-developed and

- given the restrictions on international diversification and in domestic equities.

E Case for a Review of EPF's Investment Policy

1. The EPF's investment and accounting policy should be adapted, if necessary, on a phased basis, to conform to international best practices. EPF's investment policy should be such
 - that it should invest its funds on a portfolio basis and in marketable securities to maximize its returns and to minimize volatility (with one-fourth to one-third invested in global and regional securities but these overseas investments should be phased over a period of 10 years) to reap the benefits of diversification and to overcome the short-supply of marketable securities of domestic origin.
 - that it should mark-to-market its portfolio (if necessary over a three-year time frame) and
 - that it should benchmark and evaluate the performance of its portfolio in relation to the performance of the market (and not in relation to an absolute target return that is not related to how the market has performed).
2. EPF's recent decision to reverse its long-held policy of not seeking board positions in the public listed companies (PLCs) it has invested is a very troubling one.¹ Managing the huge size of its fund is a daunting task even for the most able pension fund manager. And EPF's governing boards and senior managers are already stretched, and possibly beyond prudent limits, in managing that fund given the constraints within which they have to operate. It does not make sense for EPF to take on the added governance responsibilities of its investee companies. It is best for EPF to be as detached as possible from the management and governance of its individual investee companies so that it can vote with its feet from any of its investments which are under-performing or take actions against the

¹ See the story on "EPF Wants Boardroom Leverage" in StarBiz, February 22, 2003.

board and management of any investee companies which have been mismanaged or defrauded. To exercise its exit option through the marketplace, it should only invest in marketable securities and on a portfolio basis (as emphasized earlier).

F The Case for Investing Abroad

- 1) a) The size of EPF is very large relative to our domestic financial markets;
 - if it is not allowed to invest abroad EPF will register lower returns and higher risks;
 - between 20 – 25% of EPF funds are now invested in money market (MM) assets;
 - This over-investment in MM assets by a pension fund is not justifiable.
 - b) EPF should always invest on a portfolio basis and in marketable securities to ensure good governance.
 - c) We must take care of interest of savers and investors and not only of borrowers or bankers. Current regime of exchange control favours borrowers, businessmen and bankers but discriminates against savers and investors who are mainly employees and who face severe restrictions on their saving and investing for retirement.
 - d) Malaysia has been registering a current account surplus for several years. This dictates a need for the country to invest abroad. Should such investments be undertaken by BNM or the private sector and as business ventures or on a portfolio basis? I believe a mix of investments is preferred.
2. a) Pool of retirement savings will become larger as life expectancy increases and as employees work longer to build their savings to support themselves in retirement.
 - b) Size of domestic financial markets are small relative to this growing pool of retirement savings.
 - c) If EPF is forced to invest only domestically returns will be lower and risks will be higher. Paradoxically this will necessitate still more savings for retirement.