Reform of the Fiji National Provident Fund

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INTRODUCTION

The Fiji National Provident Fund (FNPF) is a workers' retirement savings scheme, taking mandated contributions from employees and their employers and accumulating these into retirement. It shares a similar philosophical approach to other provident funds such as the Singapore Central Provident Fund and the Malaysian Employees Provident Fund, and like them, operates on a fully funded basis without government subsidy.

The principal role of such funds is to accumulate benefits for retirement. In the case of the FNPF, an option to receive a pension from age 55 was introduced in 1975 on a basis which was quite clearly not self supporting, and hence necessarily was going to require significant subsidy from active members as the number of pensioners grew. By 2011 the scale of the problem was such that drastic reform became essential. After first canvassing the possibility of reducing pensions, a solution was found which has not, to the knowledge of the author, been applied elsewhere. Briefly, pensioners were refunded their pension conversion amount, and invited (and encouraged) to reinvest at actuarially sustainable rates.

This paper is organized into two parts after a brief background. The first part gives a brief history of the scheme, up to and including preliminary reform proposals canvassed in early 2011. The second part deals with the actual reform implemented by the FNPF in November 2011. Note that all figures are in Fijian dollars (approx 55c US).

BACKGROUND: MEMBERSHIP, PENSIONERS AND ASSETS

At the most recent balance date, 30 June 2011, the FNPF had 302,729 contributors with non-zero account balances, totaling $2,997 million. The total population from the 2007 census was 837,271, 30% of whom were under 15, and 60% (500,049) between age 15 and age 55, the latter being the age at which FNPF members are entitled to access their savings, whether or not they have withdrawn from work. . Around 80,000 of the population were aged 15 to 19, and a similar number were aged 20 to 24.

The number of pensioners at 30 June 2011 was 11,468, and the accrued liability was calculated as $565 million. The total population aged 55 and over was 94,101 in the 2007 census.

Total assets under management at 30 June 2011 were $3,786 million, of which 86% was in fixed interest and cash. Some 55% of assets were Fiji government bonds and another 10% were quasi-government bonds. Currency restrictions imposed by the Reserve Bank of Fiji prevented any significant external diversification.

PART 1: 1966 TO AUGUST 2011

Beginnings

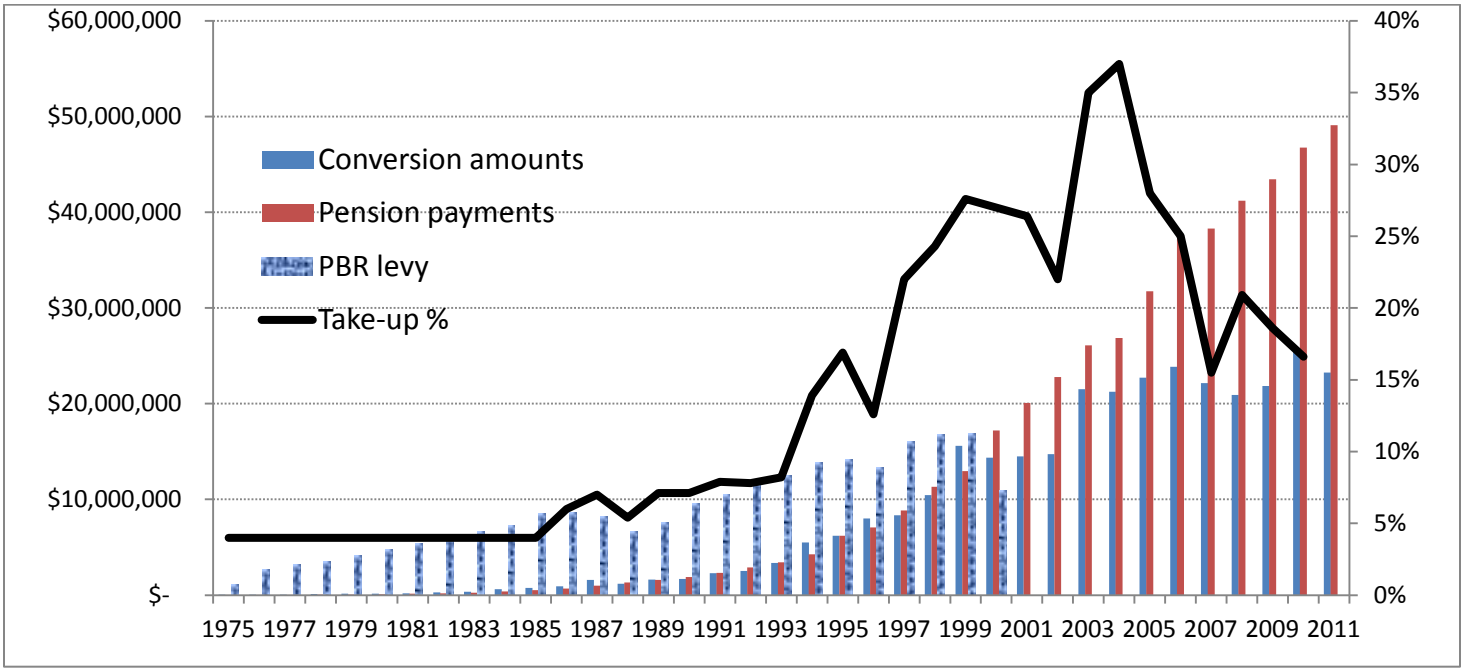
The FNPF commenced IN 1966. In 1975 a decision was made to offer retiring members a pension from attainment of age 55. The conversion rate was set at 25% for a sole pension, and 16.7% for a joint pension. That is, a pension of 25% of the amount set aside – the pension conversion amount, as it is known – became payable for life if sole, and 16.7% of the conversion amount for the life of the pensioner and spouse if joint. The author is unaware of what was known about life expectancy at age 55 at that time, but there is no reason to suppose it was anything below something of the order of 15 years.

As the rate did not change with retirement age, there was a clear incentive to take the pension from age 55. It was possible to do so and remain in work, although subsequent accumulations were prohibited from being applied to a pension and instead had to be taken in cash.

It is understood the rationale put forward for such a high conversion rate was to encourage members to take up the pension option and to provide meaningful pensions from low accumulations (the scheme having been in force only 9 years). It was recognized at the time (at least to some extent) that the rate was generous, and a levy of 2% of active member wages was imposed and recorded in a Pension Buffer Reserve (PBR). Contributions had been 10% of wages (split 50/50 between employee and employer) up until 1975; these were increased to 12%, maintaining the 10% for member balance accumulation. In 1980 contributions were increased to 14%, giving 12% for accumulation.

The PBR was shown in the financial statements and recorded the pension conversion amounts credited and the pension payments debited, as well as the levy. No actuarial reserving was established, and the levy was not actuarially based. Chart 1 shows the operation of the PBR through to 2011.

Chart 1: Operation of Pension Buffer Reserve, FNPF, 1975-2011



The chart indicates how cash flows may have masked any real appreciation of the liabilities being incurred. Given low pension take-up rates, plus matching of conversion sums and pension outgo through the growth stage to the end of the century, the PBR levy dominated the financial reporting. One may observe that such a cross subsidy from active members to those who chose a pension was rather unusual, and as structured, had some Ponzi scheme-like attributes. Only the cash flow appears to have been monitored, and perhaps the continuing absence of any appreciation of the likely consequences was due to low actual take up of pensions, despite the incentive.

Reform mid nineties

The basically unsustainable nature of the pension conversion rate finally became the subject of serious examination some 15 years after its inception. A report in 1993 by Giovanna Ferrara, an actuary for the International Labour Organization, stated the conversion rate needed to be brought down to 10%, and proposed this be done over a 10 year period, using the PBR balance to finance the transition period. A subsequent report in 1994 reviewed the ILO findings, and while it was agreed that 10% might be the right rate, the phasing in period was recommended to be 15 years, and to be "held" for further review when 15% was reached. The reports also agreed that the PBR levies should cease, given the poor value they represented for most members.

These reforms were introduced in 1998, reducing the 25% to 15% over 10 years starting from 1999, with the PBR levy ceasing in 2000. It is not clear why slow phasing in was seen as so essential, and indeed one MP, a professor of economics at the University of the South Pacific, forcefully expressed the opinion that the rate should be reduced immediately to 15%.

This reform did not of course address the real issue. The take-up rates shown in the chart above (rates before 1982 estimated) are by numbers, not amounts, but give some indication of the increasing liability being incurred by providing unsustainable levels of conversion. The high take-up in the mid-2000's may have been from people taking the pension as soon as they reached age 55, rather than continuing to accumulate, in order to get in before the conversion rate fell further. It will be observed the pension payments continue to grow, but from about 1999 onward the purchases flatten out, as the number of retirees stabilizes.

World Bank reports

The World Bank and IMF provided a technical note as part of their 2007 Financial Sector Assessment Program report on Fiji, covering the FNPF. The report described the annuity business as highly unsound. The financing of the pensions, by transferring resources from active workers, was characterized as a heavy cross-subsidisation from poorer and younger workers to older and richer ones. The principal policy recommendations were:

1. Place the annuity business on a sound and fair actuarial basis
2. Implement a separation of accounts by major area of activity
3. Compile detailed records on the mortality experience of pensioners.

In regard to that third recommendation, one may note the FNPF requires pension renewal certificates every six months, but does not follow up on the reason when no certificate is forthcoming, not having considered there a business reason to do so. The record of pensioner deaths is therefore patchy, at best.

The World Bank also followed up with some modeling work in 2008.

Actuarial valuations and modeling

Starting from the balance date of 30 June 2008, Mercer Consulting was appointed to carry out actuarial valuations of the pension liabilities. For valuation, in the absence of scheme-specific data, the actuary had to make some broad assumptions as to mortality (and longevity improvement) founded on general considerations of pensioner mortality, although based on Fiji population mortality. For the 30 June 2008 valuation, life expectancy figures from 2001 were scaled to Australian data, and with mortality improvement gave projected life expectancy at age 55 of 17.9 and 21.4 for males and females respectively. By the last valuation, that as at 30 June 2011, 5 year mortality rates based on the experience from 2001 to 2008 had been published by the World Health Organisation, showing life expectancy at age 55 of 18.6 and 22.6 for males and females respectively. Continued application of mortality improvement based on Australian experience resulted in projected life expectancy of 24.9 and 27.9 respectively.

The assumed return on assets was based on the return on book value, and as the government bonds were valued on a “hold to maturity” basis, initially 7.0% pa was used as a discount rate after deduction of 50 basis points for expenses. By the 2011 valuation a net 6.5% pa was employed.

The inclusion of the liability in the accounts started making clear that existing pensions were imperiling the solvency requirements that the regulator, the Reserve Bank of Fiji, was intending the FNPF to meet, and that bringing down the conversion rate would not, of itself, ensure the soundness of the FNPF. Modeling work indicated continued solvency would require continued diversion of a part of the return on investment earned on member account balances to instead support existing pensions, of something like 50 to 100 basis points.

Initial reform 2011

The FNPF commissioned consultants Promontory early 2011 to develop new legislation with the levels of governance and separation of funds that reports such as the World Bank and IMF had recommended. New, age-based rates were developed using the basis adopted by Mercer for liability valuation. For a 55 year old, this gave a conversion rate of 8.7%, compared to the current 15%. Initial proposals had these rates phased in over 5 years.

To address the ongoing subsidy required in respect of existing pensioners, the reform proposals canvassed a variety of “haircuts” in respect of current pensions. Generally pensions below $800 per month were to remain unaffected, but for example one proposal had reductions of 15%, 20%, 25%, 30% and 40% for each subsequent $800 per month tranche of pension, with a 50% reduction of anything that then remained over and above $5,600 per month.

The reform proposal was consulted on and the pension reduction aspect was not well received by the better off pensioners, who argued that they had a contract and any amendment to the governing

legislation could not change it. One such pensioner made application to the High Court in a test case pleading that his human rights would be violated should the government attempt to change the rules. The Court did not immediately dismiss the case but granted the plaintiffs time to better develop pleadings. The case had not returned to the Court when the final form of the reform was enacted on 25 November 2011. This is described in the next section.

PART 2: SEPTEMBER 2001 TO PRESENT

The big idea

A reduction in existing pensions was a fundamental requirement of any reform, if the unfair cross subsidy from active members was to be brought to a halt. Although advice was the legal challenge mentioned abovewould not succeed, modeling also indicated that the level of reductions on which consultation had occurred would be inadequate in terms of the nil cross subsidy objective and achieving solvency of the fund.

Analysis of the accounts as at 30 June 2011 showed a solvency position as per Table 1. This incorporated the new requirement that a solvency reserve of a minimum 10% of member accounts be established, in view of their capital guarantee – unitization (or allowing a negative crediting rate) had been proposed, but any possibility of member accounts having negative returns was rejected.

The asset values shown are as per the accounts. Government bonds, which make up 55% of the assets by book value, and other fixed interest, another 10%, are held to maturity and recorded on that basis. The Reserve Bank of Fiji issues monthly a table of indicative bond prices based on a limited number of bond tender results, and these prices suggested that market value at that date would be some $344 m higher. As noted above, the actuarial valuations had assumed pension liabilities would be backed by the portfolio's long-dated, high coupon bonds, anticipated to yield a net effective return of 6.5% pa on book value over the course of the term of the pensions in force.

The equity and property assets (including loans to subsidiaries at non-commercial loan rates), are also held at appraisal values which are always difficult to judge and may not reflect actual realisable market values. As the result of what proved to be poor decisions by past FNPF managements and Boards, some of these assets have had impairments recorded against them, but may still remain overstated. Table 1 therefore needs to be read with some caution, but bearing in mind nothing better is available.

Table 1: Summary of FNPF solvency, 30 June 2011 - $FJD million

Total assets	**$3,768**
Member accounts	$2,997
Solvency reserve for above	$300
Pension liability	$565
Death benefit reserve	$19
Total liabilities	**$3,881**
(Deficit)/Surplus	**($113)**

The liabilities shown here do not include any solvency reserve for the pension liability, the basis for which was still to be determined.

At a meeting in September 2011 to discuss options, Shauna Tomkins, a consultant from Promontory, observed that pension conversion amounts for current pensioners totalled $310 million. As the pension liability was $565 million, she proposed termination of the entitlements and refunding to current pensioners their original conversion amounts. Pensioners would then be invited to purchase a new pension product offered on a sound actuarial basis. The future rates would then be introduced without phase-in. This action would free up $255 million that had been withheld from returns to members. In the future, member savings and pensions would be offered through separate funds. The general idea was to share the "savings" between members and pensioners by allocating $113 m to meet a prudent reserve on member savings, , $31 million as an ad hoc provision for a pension solvency reserve, and leaving $111 m to be applied as an incentive to those pensioners who received a refund in the form of "top ups" to pensions to mitigate the effect for those on the lower levels and provide some minor incentive for those on the higher levels. Table 1 would then become:

Table 2: Revised summary of FNPF solvency, 30 June 2011 - $FJD million

Total assets	***$3,768***	**$3,768**
Member accounts	*$2,997*	$2,997
Solvency reserve for above	*$300*	$300
Pension liability	*$565*	$310
Pension solvency	*$0*	$31
Death benefit reserve	*$19*	$19
Total liabilities	***$3,881***	**$3,657**
(Deficit)/Surplus	***($113)***	**$111**

The author, being at that meeting, can testify that initial reaction, including his, was one of doubt. After a little time to digest the idea, however, its merits became fairly plain. In effect, the FNPF had issued "bonds" to its retirees incorporating a high and unsustainable coupon; it made sense to recall these "bonds" and re-issue them at a sensible rate. The past over-payments were a sunk cost, but a clean start could be made. (The bond analogy is not quite perfect; one has to posit that the coupon included compensation for the loss of the principal on death, but 2-300 basis points was quite adequate for that at age 55.)

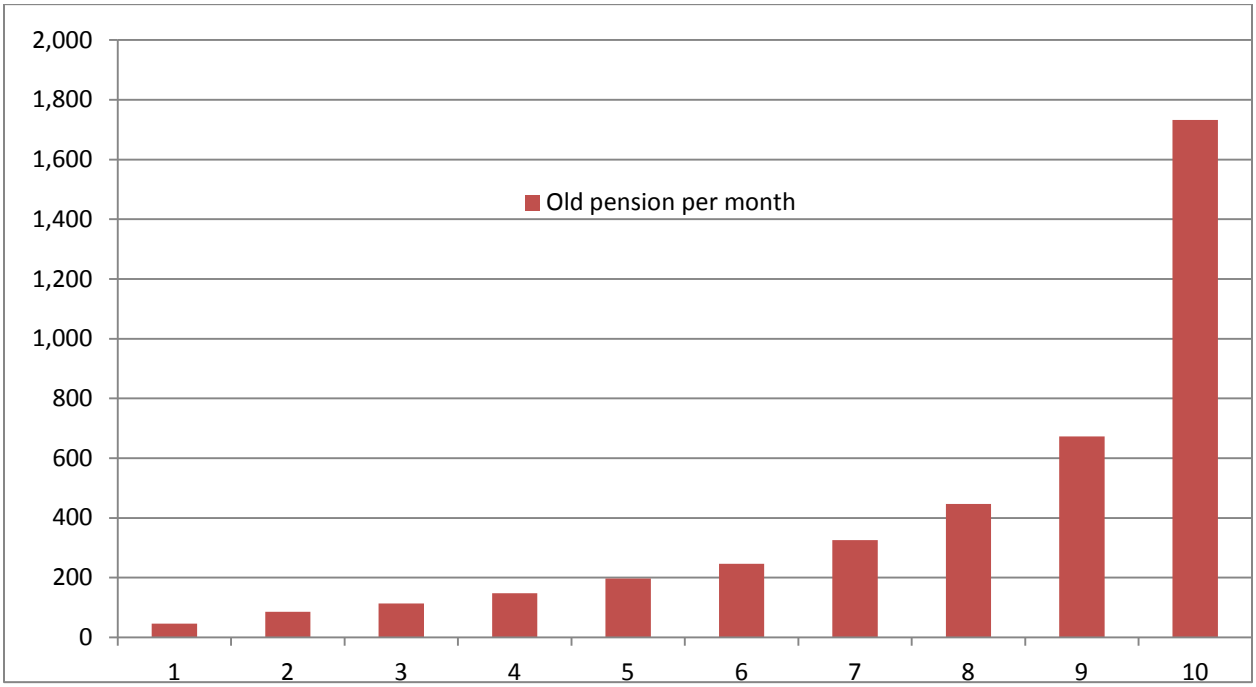
Design issues

The new pension rates were priced on a 6.5% pa net yield. This was the rate of return adopted for the 30 June 2011 valuation, and justified by the holding by the FNPF of substantial quantities of high coupon long dated Fiji government bonds. These were booked at hold to maturity values, and were effectively holding back investment return for slow release. Given that market rates, to the extent they could be said to exist, were rather lower than 6.5%, and payments were tax free, this meant that the new pensions were still good value for money. Mortality pricing was based on population mortality but with improvement consonant with that observed in the Australian population, which could be deemed

sufficiently strong to provide some allowance for differences between pensioner and population mortality.

The principal design issue related to the top ups. In essence, this was a redistribution matter since reductions at each age would otherwise have been in proportion to the pension. As reductions were of the order of 40% to 50% or more, except for the older pensioners, those on very little would have had even less. The distribution by deciles of pensions before the reform was as follows:

Chart 2: Distribution of pension per month by deciles



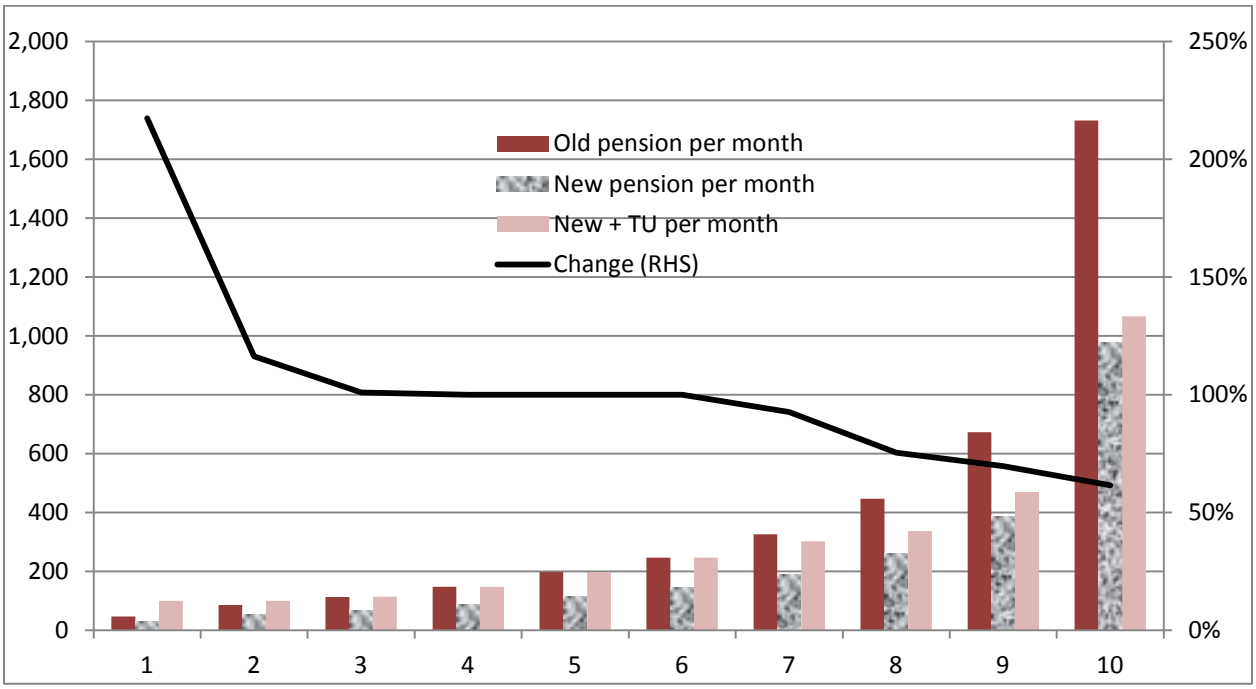
(It will be noted that the reduction in pensions as originally proposed would only have affected the top decile plus some in the 9th.)

Design elements for the top up were considered in three parts:

- A minimum pension
- A protection level, below which no pension would be reduced;
- A sum from which additional pension could be bought.

A number of variations were investigated, costed, and discussed. The final format determined was a minimum pension of $100 per month, protection of existing pensions up to $300 per month, and for those whose old pension was above $300 per month, either a top up to $300 per month (if the new pension was below $300 per month) or the pension that could be obtained from a lump sum calculated as the lesser of $10,000 and 25% of the original conversion amount. This had the effect that around 2,000 bottom end pensioners were better off, some 5,000 had no change, a further 2,000 were left with a reduction of 0-30%, another 1,000 with a reduction of 30-40%, and a final 600 or so with reductions above 40%. This last group were generally those with the highest conversion amounts, and for whom the top up produced proportionately little increment. This is shown graphically below, in terms of the deciles as above.

Chart 3: Old pension, new pension and new pension plus top up per month by deciles



To qualify for the top up, all the refund had to be reinvested in a new life pension. This was partly for administrative reasons, but also to signal that the purpose of the top ups was to encourage maximum annuitisation. There were however some selection effects to deal with. For those currently on sole pensions, their old pension was higher than that which they would have received had they chosen joint life - indeed, half as much again for those who retired prior to 1999. Had those on pensions below $300 per month been allowed to switch to joint, then they would have had a relatively lower new pension and a correspondingly higher top up. This was not a minor effect; allowing the sole to joint switch would have almost doubled the top up cost. Reluctantly – because it would have been desirable to encourage joint pensions, and in theory pensioners should have had complete freedom how they reinvested their money – top ups were barred for conversion from sole to joint.

To ensure that pensioners were confident of getting some value for money, the new pensions are guaranteed 5 years. However, extending the guarantee to the top up pensions it was thought would have unduly advantaged older pensioners, and hence the top up pensions are not guaranteed.

As an alternative to taking a lump sum, a term annuity product was also introduced. This was priced on a "new money" basis and did not have any top up or other incentive, but is proving attractive as a way of ensuring a return of all one's investment while getting an income stream.

A further new product, an account-based pension or drawdown facility, was also seen as desirable. Unfortunately the IT system changes needed to cater for the change strained capacity to the maximum, and the introduction of account-based pension has been deferred.

Implementation

Given the reliance on pension renewal certificates, particularly from remote areas where compliance with checking procedures was difficult to monitor, the potential for fraud was clear. Hence with the cash refund "in play" it was essential to take the opportunity to validate all current pensioners. FNPF staff were seconded to be "pension counselors", and were given training in the background of the reforms, how to manage pensioner interviews, and other skills. A centralized pension counselor database was developed, with multi-user access, and usable from remote locations.

Despite some teething problems, this appears to have worked well. The pension interview was an opportunity for the benefits of retaining a pension to be talked through, and other courses of action discussed. As a side effect, the staff who carried out the counselling have of necessity been upskilled in their knowledge of financial products, which may have positive downstream effects for the currently under-developed financial services sector in Fiji. By mid-March 2012 around 9,500 of the 11,000 or so pensioners on the books had had face to face interviews, including interviews on Skype with those residing overseas. Scanners were used to capture validation documentation, as well as photos and thumbprints.

Preliminary indications, given by about half those counseled, were that about 55-60 % by value would retain pensions, with 40-45% taking the lump sum. A higher pension take up had been hoped for, 80% by value, but given the difficulties of geographic dispersal and the well-known preference for immediate cash sums, something like a 60% take up by value may not be a bad result. It will be appreciated that with the high concentration of pension wealth in the tenth decile, and decisions there strongly favouring cash because of the minimal effect of the top up, the proportion by value was likely to be driven by that 10th decile opting largely for cash. By the end of April something like the full picture should be available.

Objections

The final reform did draw some objections, principally from those with the most to lose, although to be fair there was also an element of principle discernible from time to time. These objections are summarized and discussed as follows.

<u>Current pension rates are sustainable</u>

This view could only be supported by a very negative view on pensioner mortality, given the high conversion factors, even after the reduction in the conversion actor to 15% phased in from 1999 to 2008. Nothing produced by the World Health Organisation gives any credence to such a negative view. An examination of the FNPF experience shows the accumulation with earned investment yield on purchase amounts in and payments out is now significantly negative, even with an allowance for the Pension Buffer Reserve levies of the pensioners themselves, of the order of $100 million in deficit. This exercise also showed that future payments for existing pensioners, even if new rates were introduced immediately, would require increasing levels of member subsidies.

<u>The FNPF is breaking contracts</u>

This is a legal argument and one on which the author is not qualified give a definitive opinion. However, pensioner entitlements arose out of a statutory instrument, and given that the amounts put aside for

the pension have been returned without penalty and the pensioners have enjoyed much better than average investment returns, then a legal challenge was not considered likely to succeed. The new law provides protections against future legal challenge, but that was a matter of expedition rather than any concern about the legal foundation.

Conceptually, it would have had the same effect had the FNPF established a new entity for members and transferred to it the member balances and the required solvency margin. This would have left the current pensioners to make their own arrangements for dealing with the insolvency. This would have obvious pitfalls in terms of ensuring all pensioners were treated fairly, and required significant legislative change; nonetheless it makes clear that it is a separation of funds that is the objective of the reform.

The FNPF legislation incorporated a Government guarantee

The legislation in fact provided only that the Government could advance money should the FNPF get into difficulties. The advance however had to be repaid as a priority. This section has never been called on or otherwise tested. In the event that it became apparent that a claim might be made in circumstances where the advance could not be repaid, it is not unreasonable to assume the government would not accept this outcome.

The Pension Buffer Reserve was misused

The particular complaint is that no interest was added to the Reserve. However, as it was, the PBR levy represented a massive subsidy from active members to the relatively few who became pensioners; diverting interest would have only exacerbated that subsidy. In most years prior to 1998 the crediting rate to member accounts exceeded the actual return on investment, the source of these funds being interest that was otherwise earned on unallocated assets (reserves). This was to the advantage of those who subsequently retired and took pensions as well as to those who took a lump sum. In recent years the crediting rate has been below the return on investment as the FPNF attempted to build reserves to meet anticipated pension costs.

Pensioners are being forced to pay for bad investment decisions

Past FNPF managements, possibly encouraged by past governments, have made poor investment decisions. This has been to the detriment of the amount available for crediting member balances, however; it does not alter the basic lack of sustainability of the pension conversion rates being used.

Pensioners have budgeted for the future and now have to readjust without the capacity to replace earnings

This is a valid issue for those members who chose to take a pension at a lower level or self-manage their refund and cannot find equivalent replacement income. One can observe that over 7,000 of the 11,000+ are not so affected, and many more only to a minor extent. One can also observe that some are in a position to continue in work, and have been doing so and have accumulated further member balances which they are now able, under the new legislation, to use to make up the shortfall. And the top ups were maximized to use all the available “surplus” released.

Nonetheless, it remains a real issue, and one for which there was no solution, unless a subsidy from members was to continue. That had however been ruled out, as a basic principle of the reform was to ensure members had every chance to build up decent retirement balances. One calculation was that the necessary subsidy would have reduced the average future member accumulation by 30%.

Conclusion

The FNPF Board and Management inherited an untenable situation; they accepted advice for comprehensive and definitive solutions to long standing problems; they addressed the pension problem and attempted to minimize the inevitable adverse impact of rebalancing a scheme that so favoured a small group over the majority. FNPF needed to keep the government onside for legislative change, and explained the position well; politically, it was possibly assisted by an "anti-privilege" stance one can perceive in the current regime, and the focus on securing the retirement balances of the active contributors would certainly have helped.

The FNPF has however struggled a little in the face of a vehement campaign of opposition by some of the most affected pensioners, who have made effective use of PR and spin to promote their case. Various elements of misunderstanding and even misrepresentation have had to be dealt with. Those opposed to the current political regime have seized upon the reform as an example of government oppression, even though in fact only a relative few are affected, and many, many more will benefit.

In some ways it is a pity that there has been such a public focus on the change to current pensions, as the improvements in FNPF governance, supervision, and elimination of cross-subsidy are all extremely worthwhile. In the end, one may hope that as observed by one of the participants in the reform, it will be accepted that there are in fact no losers, just some who have stopped winning at others expense.

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