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The Malaysian Pension System

Background

Malaysia will become an ageing nation in the not very distant future. Based on the latest projections from the Department of Statistics Malaysia (DOSM), the proportion of the population above 60 years old will hit above 15% sometime between 2030 and 2035 (DOSM, 2016a). This evolution in the age profile of the population has come through a number of factors – declining fertility coupled with longer and healthier life spans – and is occurring at a faster rate than heretofore has happened. It is estimated that Malaysia will transition from a population with 7% above the age of 60, to one with 14% above 60 in just 25 years. By contrast, the same transition took the UK 45 years, and the United States 69 years (Kinsella & Gist, 1995).

Given this circumstance, income security for the elderly is a key policy priority. Historically, Malaysians have depended on the family unit as the primary care givers for the elderly, regardless of ethnic background (Chan, 2005). This is slowly breaking down, as internal migration and declining household sizes reduce the ability of children to care for their parents (DOSM, 2010). This places greater pressure on the national health system and social services to pick up the slack, with varying degrees of success. As a result, the provision of retirement income is taking on much greater importance, a trend that will continue as the population ages.

On that basis, the reach and adequacy of the Malaysian pension system is undergoing greater scrutiny. Based on the World Bank's multi-pillar pension model (Holzman & Hinz, 2005), Malaysia has most of the elements required of a pension system, but also has significant gaps. Even within the pillars that have the requisite institutions, there remain challenges in terms of coverage and adequacy that need addressing.

The purpose of this research note is to outline the history and current state of the pension system in Malaysia, including a thumbnail sketch of the institutions involved. The paper will begin with an overview of the demographic situation, followed by a short history of the development of the pension system in Malaysia, and end with some policy options for consideration.

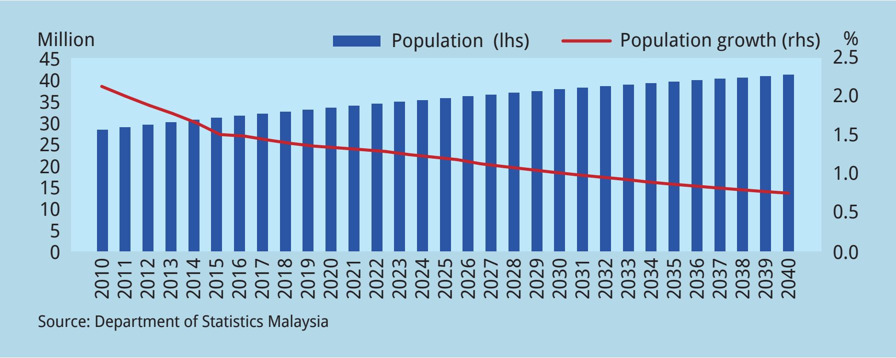
Demographic Changes in Malaysia

Malaysia is undergoing a significant demographic transition. Population growth has dropped from an annual average of 2.5% in the 1970s to 2.0% in the 2000s, while the latest population projections suggest population growth will drop below 1% per year by 2030 and 0.6% by 2040 (DOSM, 2016a) (Figure 1). Sometime in the next two decades thereafter, Malaysia's population is probably going to stop growing entirely.

In the meantime, declining fertility rates and increasing longevity mean an equally significant change in the population age profile. The total fertility rate dropped below the 2.1 replacement level in 2013, while life expectancy at birth has increased from 61.6 and 65.6 in 1970 (for men and women respectively) to 72.5 and 77.4 in 2015 (DOSM, 2016b) (Figure 2). Expectations are that as Malaysia continues to improve on healthcare, life expectancy will continue to improve in line with global trends.

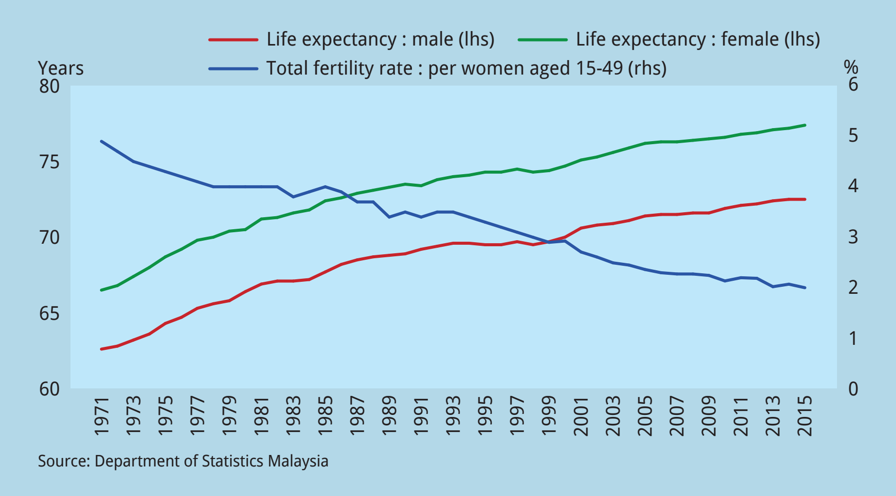
From an economic perspective, Malaysia is still undergoing what is termed the

Figure 1: Projected Population and Population Growth 2010-2040



Source: Department of Statistics Malaysia

Figure 2: Life Expectancy and Total Fertility Rate 1971-2015



Source: Department of Statistics Malaysia

first demographic transition. In a stylised demographic transformation model, better healthcare and living standards translate into increased longevity. This happens concurrently with declining fertility, as declining child mortality reduces the incentive to bear children. The end-result is that a "bulge" has appeared in the Malaysian population age-profile starting with the cohort born in 1980, with a slowly declining youth dependency ratio, and an increasing proportion of the population in the prime working age bracket of 15-65.

Coupled with policies to enhance labour quality (such as education), the first demographic transition is likely to result in faster economic growth per capita, as a larger, better educated population boosts consumption, investment, and productivity while they remain in the workforce.

However, the age cohorts behind this bulge are smaller. As of 2015, the population between the ages of 10 and 14 is already 2.5% smaller than that in the 15-19 age bracket. Similarly, the cohort following (ages five-nine) numbers 5.8% less than the one before, though the youngest age bracket shows a small increase of 3.1% (though it is still smaller than the 10-14 cohort) (DOSM, 2016a).

All things equal, as the first demographic transition will boost economic growth, the second transition (as the size of age cohorts declines) will likely have the opposite effect, though whether this will result in an absolute decline in the population is as yet unknown (van de Kaa, 2002).

The Development of the Pension System in Malaysia

Unlike many developing countries, Malaysia had a head start in providing for income adequacy for retirement, with both public and private sector pension schemes introduced in 1951, even before independence from the United Kingdom in 1957. The Malaysian pension system now has a number of different institutions that fall into five different areas, serving mostly different constituencies:

1. a tax-funded defined benefit (DB) pension scheme for public servants;
2. a defined-contribution (DC) scheme for armed forces personnel;
3. a publicly run, DC retirement scheme for private sector employees;
4. a publicly run social insurance scheme for private sector employees; and
5. a privately run, DC scheme open to all.

In addition, there are government funded welfare benefits that target the poor. While these benefits provide supplementary incomes for the eligible elderly, they are not pensions in the ordinary sense of the term, and thus are not addressed in this paper. While the Malaysian pension system as a whole appears comprehensive, gaps in coverage remain and issues of adequacy have yet to be adequately confronted.

The public service pension system

The public sector system is funded out of general taxation, and is a non-contributory, DB system that pays out up to 60% of last drawn salary for civil service retirees and confers both survivorship benefits and subsidised healthcare for life. There are currently 743,000 pension beneficiaries under the system (KWSP, 2016). The public system was first established for what was then Malaya under the Pensions Ordinance of 1951, which superseded the existing law that was in place for the Federated Malay States*[1] which was first promulgated in 1928. The Pensions Ordinance was eventually replaced by the Pensions Act (1980), which continues to be the main legislation governing the pension system today. Statutory bodies and local authorities were brought into the scheme in 1976 (Lee, 1997), after previously being under a separate scheme that began in 1969.

Various changes have been made to the scheme over the years, the most important of which were changes to the mandatory retirement age, in line with increasing life expectancy. The mandatory retirement age was originally 55 years in 1951, but was raised to 56 in 2001, to 58 in 2008, and to 60 in 2012. A lump sum gratuity was introduced in 1968, while cash in lieu of leave-not-taken was introduced in 1974. A pension adjustment was also introduced in 1980 (Lee, 1997), so that changes to the public service scheme of service would also apply to current retirees, and not just new ones. This allowed for cost of living adjustments for pensioners, to cater for the impact of inflation.

The key elements of the current scheme include (Jabatan Perkhidmatan Awam, 2018):

1. A monthly service pension calculated as 1/600 x months of service x last drawn salary, subject to a maximum of 60% of the last drawn salary. The maximum pension benefit applies after 30 years of service;

2. A lump sum gratuity equal to 7.5% of last drawn salary multiplied by month of service;

3. A cash award in lieu of leave not taken;

4. A disability pension, for civil servants who are incapacitated in the course of duty, with a maximum benefit of up to 50% of the last drawn salary; and

5. A pension for dependents (including children under 21 and parents) of a civil servant who dies in the course of duty.

Pension rights vest on completing three years of service, and both the gratuity and cash award are exempt from income tax.

To reduce the burden pension payouts placed on government finances, the Pensions Trust Fund was established in 1991 with an initial endowment of RM 500 million, and was later incorporated as the Retirement Fund (Incorporated) or Kumpulan Wang Amanah Pencen (KWAP) in 2007 (KWAP, 2016a). As of September 2016, the fund size stood at RM 126.87 billion (KWAP, 2016b). Nevertheless, the government has yet to draw down the funds managed under KWAP, and all pension benefits are on a Pay-As-You-Go (PAYGO) system, with current taxation funding current retirees. However, the administration of pension benefits was transferred from the Civil Service Department (Jabatan Perkhidmatan Awam) to KWAP in 2017.

The drawbacks of such an arrangement are obvious with an ageing population – pension benefits paid out are increasing much faster than revenue growth, and are an increasing proportion of government expenditure. From 2.7% of operating expenditure in 1977, pensions and gratuities to retirees have increased to 8.7% in 2015; in absolute terms, the increase has been nearly a hundred-fold, relative to an economy that expanded roughly 36-fold (Bank Negara Malaysia (BNM), 2016b) (Figure 3).

Armed Forces Retirement Fund

In addition to the overall public system, a separate system exists for enlisted armed forces personnel under the Armed Forces Retirement Fund or Lembaga Tabung Angkatan Tentera (LTAT), which was established in 1973. Unlike the DB public sector pension, this is a fully funded DC scheme, with contributions from both members (10% of salary) and the government (15%), although it is possible for members to increase their contributions voluntarily. Dividends are paid out annually from investment income, while a bonus is also awarded comprising free units from LTAT's mutual fund subsidiary. Members are entitled to withdraw their savings (inclusive of dividends and bonus) upon reaching the age of 50, while the government portion is used to fund a monthly pension. While officers also have the right to save through the scheme, it is primarily aimed at enlisted personnel.

The reason for the split between LTAT and the public service is largely due to differences in the scheme of service, and LTAT is correspondingly smaller in terms of the assets it manages (2015: RM 87.8 billion) (LTAT, 2015). Enlistment in the Malaysian armed forces is for a period of between 12 to 21 years with mandatory retirement by age 55, which differs from the much longer period of service available under the public sector scheme of service. Given the relatively short accumulation period, the pension scheme for the armed forces is intended not so much to fully fund retirement (for which it is in most cases inadequate), but as much for providing capital or a financial buffer while the retiree seeks other work.

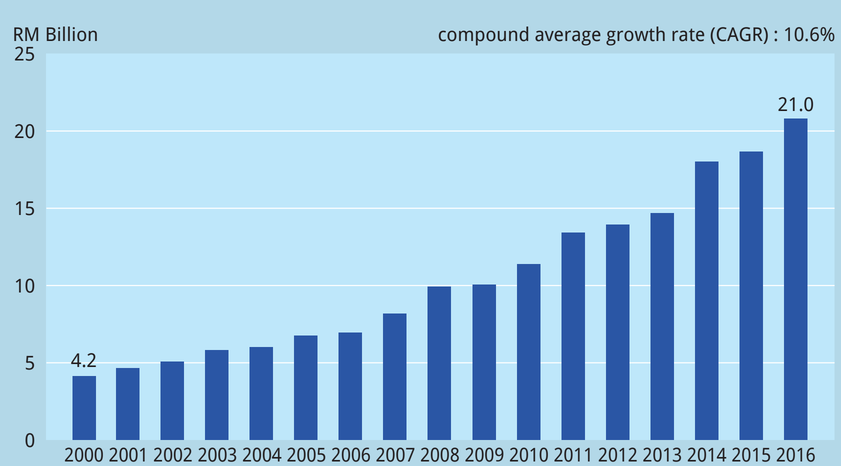
In recognition of this, LTAT runs training programmes intended for retiring and retired members to prepare them for second careers, an initiative that was begun in 1994.

The private sector pension system

For the private sector, the primary vehicle for retirement saving is the Employee's Provident Fund or Kumpulan Wang Simpanan Pekerja (KWSP), a DC scheme which was established in 1951 and is one of the oldest provident funds in the world. Both employees and employers are required to contribute to the fund, at a statutory minimum rate of 11% and 12% respectively for members earning more than RM 5,000 a month and 11 % and 13% respectively for members earning less. Members are entitled to make a partial withdrawal at age 50 and full withdrawal at the age 55, although mandatory contributions paid in after 55 are sequestered until age 60. Contributions are accepted until the age of 80, while dividends are paid out on savings until the age of 100.

KWSP is among the largest pension

Figure 3: Public Sector Pension & Gratuities 2000-2016



Source: Bank Negara Malaysia

funds in the world, ranking in the top-10 in terms of asset size with RM 730 billion under management at the end of 2016 (KWSP, 2017a). While the primary beneficiaries of the KWSP scheme are those under formal employment and earning a regular wage, the scheme is also open to the self-employed and to foreign workers on a voluntary basis. As of 2017, the fund had more than 14 million members and nearly 7 million active contributors, relative to a total labour force of 15 million.

KWSP has seen many tweaks to its scheme over the years, with the main change being the employee and employer contribution rates. It has in recent times also been used as a policy variable, with the employee contribution rate being temporarily cut to boost disposable income during recessions and economic slowdowns. Initially beginning at 5% for both employees and employers, the contribution rates were progressively raised to 6%/7% in 1975, 9%/11% in 1980, and 10%/11% in 1993, before reaching the current level of 11%/12% in 1996. Since then, only temporary cuts to the employee contribution rate have been made, in 2001-2002 (from 11% to 9%), in 2003-2004 (also from 11% from 9%), in 2009-2010 (from 11% to 8%), and in 2016-2017 (another 3% cut). In all the latter cases, the employee contribution rate reverted to 11%.

Another feature of the scheme is the subdivision of retirement accounts, with a portion set aside for non-retirement purposes such as home purchases and funding for health and education. While this results in some leakage from retirement savings, the rationale is that such funds are either used for alternative wealth accumulation (housing) or for investment in human capital (health and education) which would raise future income.

As a supplement to the KWSP scheme, the government introduced Private Retirement Schemes (PRS) in 2012, supported by tax incentives for Malaysians and their employers who participate. These are private sector administered savings schemes, with eight fund managers offering 56 different products (Private Pension Administator, 2018). In many cases, the products offer life cycle choices in terms of risk exposure and returns, with the ability to switch between different funds offered by particular fund managers. Members can access their savings via lump sum full withdrawals on retirement, with annual pre-retirement withdrawals allowed under a tax penalty. In aggregate, PRS hit 301,279 members in 2017, with funds under management of RM 2.23 billion (Private Pension Administrator, 2018). Given the relatively small numbers, PRS should be considered as a supplement to the KWSP scheme, rather than as an alternative.

Private sector social insurance

In addition to KWSP, workers and employers are also required to contribute to the Social Security Organisation (SOCSO) scheme, which provides benefits in the event of injury or disability. SOCSO was established in 1971, and its rates of contribution are 1.75% for employers and 0.5% for employees under the Employment Injury and Invalidity schemes for those below the age of 60, and 1.25% by employers only, for those above the age of 60 under the Employment Injury scheme (SOCSO, 2017). Both schemes provide multiple benefits to members on injury and invalidity, including the payment of a monthly lifelong pension.

Capital Market Impact

With the three main pension institutions managing cumulative funds in excess of RM 900 billion (as of 2016), equivalent to over 70% of 2016 GDP, they have had a major impact on the growth and development of Malaysian capital markets. KWSP alone currently holds about a quarter of Malaysian government debt securities outstanding, and all three are significant players in the domestic equity market, both in terms of holdings and in terms of supporting domestic liquidity.

However, the role of the pension system within the capital markets has evolved over the years. The Malaysian corporate debt market really only began growing strongly in the 1990s. Also, the interest rate environment has changed significantly over time, from the high inflation, high interest rate environment of the 1970s, to the low inflation, low interest rate environment after the Global Financial Crisis. This has prompted the pension institutions to change their asset allocations over time, from portfolios largely dominated by fixed income assets (particularly government securities) to progressively taking on equities, corporate debt, and most recently alternative investments such as private equity and direct investments in property and infrastructure.

In addition, there have also been moves to diversify away from the Malaysian market, and invest in a wide range of assets overseas. More than a quarter of KWSP's assets under management is now located outside of Malaysia, through both public and private markets. This has been in response to the growth of the funds, which has exceeded the economic growth of the country. Under those circumstances, there is growing concern that the heavy presence of these pension institutions in domestic capital markets is distorting valuations and reducing investment returns, for which there is some empirical evidence. Malaysia's stock market has over the years been valued at a premium over other regional markets, as measured by the price/earnings (P/E) ratio.

Rather unusually for a pension fund, LTAT has been an exception in terms of its asset allocation, with most of its assets tied up with two major listed entities – Boustead Holdings Berhad (a diversified conglomerate with interests in property development, pharmaceuticals, plantations, heavy industries, and trading and industrial) and Affin Holdings (an integrated financial services provider).

In addition to their direct investment impact on capital markets, the Malaysian pension institutions have also helped to support the development of the domestic asset management industry, via mandates given to external fund managers. The proportion however has tended to be on the smaller side relative to international best practice, as most fund management functions are still handled in-house.

Issues and Challenges

These institutions are the main avenue for institutional income support of the aged in Malaysia. Despite their relative size and coverage, substantial challenges remain in terms of ensuring both adequacy and sustainability.

Both DB and DC schemes in Malaysia suffer from adequacy problems. In the public DB system, tying pensions to last drawn salary effectively means that the rank and file of the civil service could be receiving pensions inadequate to sustain a basic standard of living, even before factoring in inflation. While benefits have been gradually raised over the years, prices of basic necessities have increased at a faster rate than the overall rate of inflation. For example, food prices have increased at a rate one percentage point above the increase in the Consumer Price Index (CPI) (DOSM CPI reports, various) (Figure 4). Even index-linking pensions to the CPI would result in a real decline in income over time. Increasing longevity exacerbates the situation, as pensions based on wages a generation ago have not kept pace with the overall increase in the price level.

The public system also suffers from an unsustainable increase in future government liabilities. While estimates of the current pension asset-liability gap are not publicly available, a full drawdown of KWAP funds would deplete the fund within five-six years (Asia Asset Management, 2016).

Within the private system, as retirement savings are dependent entirely on member and employer contributions, adequacy is an even more pressing issue. Less than 25% of KWSP members reach the minimum basic savings requirement at age 55, which stipulates enough savings to finance monthly income at or above the poverty line for 20 years (currently RM 240,000). About 20% enter retirement with less than RM 10,000 in savings (KWSP, 2016).

Coverage is an even bigger issue for the private sector, as active members (those contributing at least once a year) number around 7 million, compared to an estimated total workforce of 15 million. The most compelling problem here is the informal sector which is not covered by any formal pension scheme, and forms more than a third of the labour force in Malaysia. All told, KWSP estimates only about 3 of every 100 working Malaysians will have a pension and/or savings adequate enough to sustain a comfortable retirement (KWSP, 2017b).

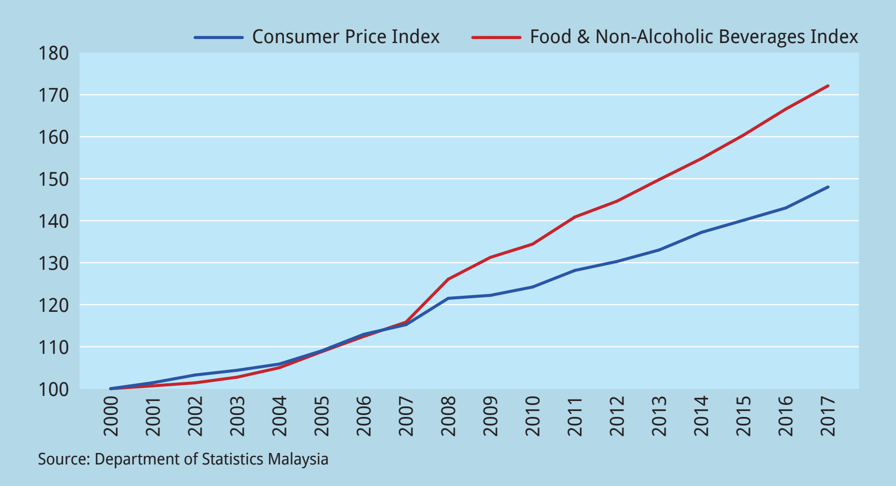
As corroboration, data from Household Income and Expenditure surveys conducted by the DOSM suggest a fifth of low income households (defined as those in the bottom 40% of the income distribution) are led by the elderly (DOSM HIES, various). It is clear that retirement savings are, on aggregate, insufficient to meet the needs of the elderly at the present time, much less into the future. Moreover, in terms of other financial assets, what data is available suggests Malaysian households, regardless of age profile, are highly vulnerable to economic shocks (BNM, 2016a).

One mitigating factor is that some of these households may own assets outside of the formal pension system, particularly in the form of housing. On that score, Malaysians as a whole appear to be relatively well off. Nationally, the rate of home ownership is above 70%, and this rises sharply for retirees (over 90% in the case of those above the age of 60) (DOSM HIES, Various).

Nevertheless, this form of wealth is illiquid and cannot be used to cover daily expenses. One possible retirement strategy is to downgrade housing on retirement, trading in housing equity for cash. However, this strategy assumes an environment of constantly rising house prices, a dangerous assumption in the midst of consecutive near-term demographic transitions. Just as demand for housing rises during the first demographic transition as a larger portion of the population enters the housing market for the first time, demand for monetising housing wealth would ceteris paribus similarly spike during a second demographic transition as the working age population declines, with an obvious negative impact on house prices and thus household wealth.

While empirical evidence for this housing market cycle is ambiguous, it is in theory highly suggestive, and appears to be supported by boom-bust housing cycles in developed economies with high home ownership, such as Japan in the 1980s and the United States in the 2000s.

Figure 4: Consumer Price Index versus Food & Non-Alcoholic Beverages Index 2000-2017 (2000=100)



Source: Department of Statistics Malaysia

Policy Options

Addressing the challenge of income security for the elderly will require a multi-pronged approach. Most potential options will be familiar to practitioners in this field, but they still bear repeating.

For income security, Malaysia needs to follow the example of many other countries in raising its retirement age. Increasing the time spent in the workforce allows for a stronger build up in retirement savings, and given that incomes generally peak around the age of 50 means that every Ringgit earned past this age has a bigger impact on retirement savings. The mandatory retirement age was raised to 60 in 2012, but already needs to be revisited again. By rights, given the continuing increase in life expectancy, the mandatory retirement age should be pegged to that increase, or roughly a one year increase in the retirement age in every four calendar years.

A second option is to look into retaining older workers in the work force, similar to the system practiced in Singapore. Singapore's mandatory retirement age is 62, but its re-employment law stipulates that all workers be offered positions, at reduced pay and responsibilities, up to the age of 67. This regulation has been very successful in retaining older workers, allowing them to not only supplement their retirement savings, but continue to contribute to society at large (Ministry of Manpower, 2017).

Option three is to provide a national basic pension, which Malaysia currently lacks. Such a pension need not be expensive, and would primarily be intended to supplement other sources of retirement savings or financial assets. For those not actively saving with KWSP or a civil service pension, which describes half the current labour force, such a pension can be augmented to cover at the very least basic living expenses.

Conclusion

Malaysia's transition to an ageing nation will be rapid, and the window of opportunity to prepare for the unique challenges involved is rapidly diminishing. The elderly can become a great resource for economic development, as life expectancy increases and people remain economically and socially active for much longer than before. But to fully embrace the possibilities and potential of an actively aged populace will require careful implementation of the correct policies that address the needs of the elderly, while accommodating the effects they will have on the rest of society.

Notes

*1 The Federated Malay States was a British protectorate comprising only 4 of the 14 states currently within Malaysia.

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