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OLD AGE SUPPORT FOR PRIVATE SECTOR EMPLOYEES IN MALAYSIA: CAN THE EMPLOYEES PROVIDENT FUND DO BETTER?

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Abstract

The Employees Provident Fund of Malaysia is the largest provident fund scheme available to private sector employees. This paper argues that with the low retirement age, the trend towards population ageing, a longer life expectancy and the erosion of the informal safety net for the aged, the Fund's protection is becoming inadequate. This is aggravated by the fact that many permitted pre-retirement withdrawals undermine old age savings and the Fund's returns on investments are declining. To upgrade protection, the Fund must minimize pre-retirement withdrawals, revamp its investment and portfolio strategies and be supplemented by other measures including capital market reforms.

Key Words: EPF; Contributors; Withdrawals, Dividends; Investment
JEL Classification: H55

I. *Introduction*

Old age security in Malaysia is provided mainly by a contributory scheme catering largely for private sector employees called the Employees Provident Fund (EPF), and the non-contributory Public Pension Scheme (PPS) for civil servants. While the PPS provides a lifelong pension and highly subsidized medical facilities even after retirement, the EPF scheme only returns the savings with the Fund as protection during old age.

The EPF is the largest provident fund scheme in the country and the "first ever national employees provident fund in the world" (www.kwsp.my). Established in October 1951 with the objective of providing financial security for workers in old age, it has witnessed impressive growth in coverage, range of benefits and asset accumulation.

Between 1954 and 2000, the number of total contributors (active and inactive) rose from 731,000 to 9.97 million. The increased coverage, rising average wages and rates of contribution have all resulted in members' contributions shooting up from RM55 million to RM17 billion during this period. Balances with the fund (the net effect of contributions plus dividends less

TABLE 1. TOTAL CONTRIBUTORS, CONTRIBUTIONS AND BALANCES (Selected Years)

Year	Contributors (million)	Contributions* (RM million)	Balances** (RM million)
1954	0.73	55	140
1964	1.49	115	1,064
1974	2.71	300	3,607
1984	4.64	2,510	20,329
1994	7.28	8,792	83,987
1999	9.54	15,192	163,967
2000	9.97	17,040	Na

Source: Lee (2001: Tables 1.1 & 1.2) & www.kwsp.gov.my
Notes: * Total contributions collected each year
**Cumulative contributions + dividends − withdrawals

withdrawals) have also grown impressively (see Table 1). In 2000, active contributors[1] accounted for 52% of the labour force and 54% of the employed population,[2] while the assets of the Fund stood at RM179 billion — equivalent to 52.5% of Malaysia's GDP.

Despite these positive developments, the EPF is becoming ill equipped to provide protection in old age. This merits concern because population ageing has emerged and is likely to accelerate. Between 1991-2000, the share of those aged 65 and over in the population increased from 3.7% to 3.9%. With a population of 23.3 million in 2000, this translates to an additional 0.9 million people above the age of 65. The median age of Malaysians has also risen from 21.9 years in 1991 to 23.6 years in 2000. Population ageing is expected to continue on account of delayed marriages,[3] declining birth rates and increasing life expectancy rates. Between 1991-2000, the life expectancy of males increased from 68.8 years to 70.2 years, and from 73.4 years to 75.0 years for females. The longer life expectancy of females has resulted in women outnumbering men in the 60-64 years age category and this disparity rises with advancing age (data drawn from www.statistics.gov.my). Furthermore, home care for the young and the aged is declining as the transition from a rural to an urban agrarian society erodes the traditional extended family.

The relatively young official retirement age, fixed at 55 years for a very long time, did not help either. Although it was raised to 56 years in 2001, the problem of providing a source of support for an average period of 14 years for men and 19 years for women still persists.

It will be argued that the EPF will be unable to provide adequate old age protection on account of at least three factors. First, most of its contributors are low-income earners. Whatever earnings they set aside with the Fund will be inadequate, given increasing life expectancy, rising costs of living and the erosion of traditional family support. Second, the

[1] Active members are those who continue to make their monthly contributions. Inactive members are those who have, at some point in their working life, contributed to the EPF but do not do so at present due to various reasons. This group includes government servants who are required to contribute to the EPF for ten years (recently reduced to three years) before opting on to the non-contributory pension scheme.

[2] Computed from data drawn from www.kwsp.gov.my and www.statistics.gov.my.

[3] The mean age at first marriage has increased from 28.2 to 28.6 for Malaysians between 1991-2000. The proportion remaining single (i.e. never married) in the 20-34 years age category has risen from 43.2% to 48.1% in the same period (www.statistics.gov.my).

EPF has deviated from its primary function of providing old age security and become a multipurpose lending institution by allowing pre-retirement withdrawals for a multitude of demands unrelated to old age protection. Third, contributors have been deprived of fair market returns on their savings due to legal and institutional restrictions on the Fund's investments and also because it has been pressured to extend below-the-market-rate loans to favoured privatized entities.

To restore it's protective role, the EPF must return to being dedicated solely to accumulating savings for old age and re-evaluating its investment portfolio and strategy. Other schemes and capital market reform must also accompany the efforts of revamping the EPF.

The paper is organized as follows: a brief description of the EPF in section 2 is followed by sections 3 and 4 that discuss factors that have diminished the average balance of contributors and the returns on EPF investments, respectively. The nature of reforms needed is outlined in section 5, while section 6 concludes the paper.

II. *An Overview of EPF Scheme*

The EPF scheme is a defined contribution, fully funded scheme. The total balance accumulated by a contributor on retirement consists of contributions to the Fund made during the working years, less permitted pre-retirement withdrawals, plus interest or (officially labeled dividends) credited to the individual's account. This balance, available on retirement, represents the "protection" afforded by the Fund.

The coverage of the Fund has been gradually extended. Presently, participation is mandatory for all private sector employees above the age of 16, including foreign workers. Although workers who fall under the government pension scheme, the self-employed and domestic workers are exempted, they can opt to participate in the EPF and enjoy the same benefits open to members.

Both the employer and employee must make the minimum rate of contribution prescribed by the Fund from time to time. As Table 2 shows, at the inception employers and employees contributed 5% of the employee's monthly remuneration (which includes all payments except service charges, overtime payments, gratuity and retirement benefits). The contribution rates have been raised for both since, and from July 1975 onwards, the employer's share has been set consistently higher than the employees share. The employee's rate of contribution was slashed for the first time in March 2001, as a move to boost aggregate demand. The rates are

TABLE 2. RATES OF EMPLOYEE AND EMPLOYER CONTRIBUTIONS

Year	Employee (%)	Employer (%)	Total (%)
1952- June 1975	5	5	10
July 1975-Nov.1980	6	7	13
Dec. 1980-Dec.1992	9	11	20
Jan. 1993-Dec. 1995	10	12	22
Jan. 1996-March 2001	11	12	23
April 2001-April 2002	9	12	21
May 2002- Current	11	12	23

Source: www.kwsp.gov.my

currently set at 12% for the employer and 9% for the employee.

Several elements may be identified on the "benefits" side.[4] The original plan allowed for only a lump sum withdrawal of the accumulated balance at the time of retirement. This balance is made up of the employee's and employer's monthly contributions (at the prevailing, prescribed rates), and an annual dividend earned by the contributor's balance with the EPF. The dividend is paid out by the Fund based on the net earnings generated from its investments, using the contributor's funds. Pre-retirement withdrawals were only allowed based on contingencies such as death of contributor, permanent disability and permanent emigration.[5]

In time, the Fund gave in to pressures to broaden its reasons for allowing pre-retirement withdrawals. Currently, these include withdrawals to: (i) invest independently (ii) make expenditures to "prepare for retirement" (iii) help a contributor purchase a house ahead of retirement (iv) finance higher education of children (v) purchase a personal computer (iv) meet medical expenses of member, spouse, children or parents. Death and permanent disability benefits (not related to the employer/employee contributions) have been maintained.

In the face of increasing demands for pre-retirement withdrawals, the Fund had to ensure that some minimum amount was preserved for retirement. Thus, in 1994, the Fund divided a contributor's balance into three accounts — Account I, II and III — holding 60%, 30% and 10% of the member's balance, respectively. All subsequent contributions are being allocated across these three accounts in the same proportion.

Account I, holding 60% of a contributor's balance, is solely a retirement fund. Since 1996, however, contributors have been allowed to shift some of the balances in this Account to other fund management institutions approved by the Ministry of Finance. This was to provide alternative opportunities to earn (possibly) higher returns than that gained from the EPF. But funds so transferred, and the earnings generated (if any), are only available to the contributor on retirement. Contributors are allowed to discontinue this at anytime and place all or part of their invested funds (and returns) with the EPF. However, several conditions govern the withdrawal of funds for outside investment [see Narayanan (2002)].

Funds in Account II (holding 30% of a contributor's balance) may be used to support "preparations for retirement," to purchase house, to finance the education of children and to purchase a personal computer. Theoretically, all of Account II may be withdrawn at age 50 in order to facilitate "preparations for retirement" (provided the contributor has not already withdrawn funds from this account for the other approved purposes) and contributors are not even required to establish the end-use of the funds. Similarly, all of the balance in the account may be used (if required) to purchase a house, provided the balance has not been diminished on account of other uses.

Rules regarding withdrawals for housing have been simplified since 1994 and a single set of rules now govern how the money is paid out to finance the purchase/or construction of a

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4 Benefits accrue to active and non-active contributors. Inactive contributors are eligible for benefits under all the schemes outlined above under identical terms. However, those who have opted into the pension scheme can only withdraw their (the employees') part of the EPF contributions and the dividends earned on it. The employers' (government's) share and the associated dividends revert back to the government. If the member had withdrawn the government component under any of the schemes (to be outlined later), the member's pension payments will be adjusted accordingly, until the sum is repaid fully.

5 Until 1953, an employee who has ceased working for two years and was unlikely to work further was also allowed to make a pre-mature withdrawal.

house. The member is eligible to withdraw the entire amount in Account II, or the difference between the price of the house plus an additional 10% of the cost of the house (to meet related expenditures), and the sum of the housing loan available, whichever is the lower sum. Balance from this account can also be used to reduce or settle a housing loan. An amount equal to the unpaid portion of the housing loan, or up to the full amount in Account II, whichever is the lower sum, may be withdrawn for this purpose. Such withdrawals can be made every five years, until the member attains retirement age, on condition that the withdrawal is used to reduce/settle the same loan.

With effect from April 2000, contributors have been permitted to make withdrawals from Account II to finance the tertiary education of children. Withdrawals are permitted once a year, for each of the contributor's children, subject to the availability of funds in the account. Insufficiency of funds for this purpose can be met from Account II of the contributor's spouse, if the spouse is also an EPF member.

The scheme that permitted withdrawals to purchase personal computers was introduced in April 2000 and was justified as an effort to make Malaysians computer literate so that they could participate more meaningfully in the emerging era of the K-economy. Initially, only members with children in tertiary educational institutions could withdraw (up to RM5,000) for this purpose. In the face of protests, this was replaced in June with a new scheme that allowed members with children above age 10 to make a one-time withdrawal (up to RM3,500) to purchase a personal computer.

Account III was established in 1995 to allow contributors to use a portion of their balances for the treatment of critical illnesses affecting themselves, their spouses, children or parents. The contributor may withdraw up to the cost of the medical bill, or the full amount accumulated in Account III, whichever is lower. Although withdrawal is only permitted in the case of ten illnesses identified by the EPF, a member can apply for illnesses not on the list to be considered as well.

Dividends paid out by the EPF increase the balances of contributors; the rate of dividend, in turn, depends on the success of the Fund's investment of the balances it holds. Although the law requires the EPF to pay a minimum (nominal) dividend rate of 2.5% per annum, in practice, rates have exceeded this since 1959[6] and showed a rising trend until the early 1990s

TABLE 3. NOMINAL AND REAL DIVIDEND RATES (Average), 1961-2000

Year	Av. Nom. Dividend (%)	Av. Real Dividend (%)
1961-65	4.75	4.25
1966-70	5.65	4.28
1971-75	6.14	-1.30
1976-80	7.25	2.75
1981-85	8.30	3.68
1986-90	8.20	6.24
1991-95	7.90	3.94
1996-00	6.78	3.56

Source: Computed from data available at www.kwsp.gov.my

[6] A law prevented the Fund from paying an annual dividend exceeding 2.5% until the market value of its assets exceeded liabilities by 10%. In 1960, an amendment removed this cap.

(Table 3). In 1995, however, contributors were shocked with a rate of 7.5 per cent — the lowest rate in 15 years, and even lower than the rates declared during the recession years of the mid-eighties. Rates dropped even lower between 1997-98 and this was blamed on the financial crisis that beset the region and its aftermath. In 2000, the dividend was 6%, and it dropped further to 5% in 2001. These poor rates were attributed to the "difficult environment of low interest rates and uncertainties of the stock market" (The Star, Dec. 27, 2001). Nevertheless, the EPF has sometimes performed more poorly than other similarly placed funds and drawn severe criticism. This issue is discussed subsequently.

Since savings are long-term, did employees' savings generate a positive real rate of return? Table 3 suggests average real rates that were positive but substantially below nominal rates in recent years. Although inflation erodes the real rate of return from all liquid savings, the important difference is that voluntary savings may be withdrawn and spent, or be converted to more secure assets to guard against inflation. Unfortunately, EPF contributors do not have this option.

On reaching retirement age, the balances in all three accounts are merged and become available for withdrawal. The member has several options to recover the accumulated funds. The first is to receive the entire balance as a lump-sum payment. The second (introduced in 1977) is to receive the entire balance in the form of periodic payments. But the Fund will determine the manner in which these periodic payments are made. The third alternative (introduced in 1982) allows the member to leave the balance with the fund and collect only the dividend earned by balance in the previous year, on a yearly basis. The principal can then be left to generate further earnings. The fourth alternative (introduced in 1994) allows the contributor to withdraw one portion as a lump sum and the rest as monthly installments, or the entire balance as monthly installments. This option is only available if the contributor has at least RM12,000 in his/her balance, the monthly amount payable is not less than RM200, and payments are made for at least 60 months.

However, should the contributor die prior to retirement, the named (legal) beneficiaries would receive the entire sum accumulated in all three accounts, according to the proportions previously indicated by the contributor. If the contributor dies without naming a beneficiary, the Fund has determined an order of priority as to who can collect the funds. Full withdrawal is also permitted on account of permanent disability and permanent emigration from the country.

Death and disability benefits unrelated to the contributions of the contributor or employer are also payable. As these payouts were increasing rapidly, the maximum payable for both cases was capped at RM2,000, effective from the year 2000.

Two tax benefits are available to the contributor and employer. First, a tax deduction is allowed for EPF contributions. But these contributions are grouped along with premiums on approved life insurance policies taken out by the taxpayer and subject to a ceiling.[7] Additionally, if the taxpayer is married, this relief is shared between the taxpayer and spouse. Currently, a maximum relief of RM5000 is available separately to the taxpayer and his spouse for contributions made to the EPF and premiums on life insurance policies, taken together. Second, since income earned by the EPF is exempted from tax, dividends paid out to

[7] The allowed amount is subtracted from the taxpayer's gross income and therefore reduces the income liable for tax.

contributors are also tax-free. In addition, dividends earned by balances with the Fund are also relieved from tax, as are withdrawals from the Fund.

Employer contributions, subject to a maximum, may be deducted in the computation of the employer's taxable income. The maximum has increased over time and as of 1998, the maximum tax deduction allowed was set at 19% of the employee's wages, although the minimum rate of contribution the employer makes is 12%. This discrepancy is supposed to provide an incentive to the employer to increase contributions above the minimum rate.

The EPF is governed by the EPF Act of 1991 and is under the supervision of the Minister of Finance. A Board, consisting of members drawn from the government, employers, employees and other professional bodies — all appointed by the Minister of Finance — controls its routine operations. The EPF is largely self-financing, with contributions, and earnings from the contributions of its members. The contributions made by employers and employees are invested, with full responsibility over such investments being in the hands of an Investment Panel. The Panel, interestingly, is separate from the Board and reports directly to the Minister of Finance. The nature and scope EPF investments are, however, severely circumscribed by the Act governing the EPF.

III. *Saving for Old Age or Multipurpose Lending?*

The EPF has undergone significant changes since its establishment nearly sixty-two years ago. The changes that have strengthened its role as a provider of financial security in old age include the widening of coverage via the gradual removal of restrictions on participation based on wage level, establishment-size and economic sectors; the increasing volume of balances arising from increases in the monthly rates of contributions (of both the employee and employer); the abolition of restrictions on the rate of dividend that can be declared, and the changes in the mode of computing dividends;[8] the enhancement of the longevity of the accumulated balances through the provision of different modes of withdrawals on retirement; and finally, the recent broadening of the investment portfolio of the Fund which can potentially increase its earnings. However, at the same time, the role of the Fund has been transformed from being one dedicated solely to accumulating resources for old age protection to a multipurpose lending institution, not only to its members but to the private sector as well (see subsequent discussion).

In seeking to provide additional "benefits," the Fund has allowed pre-retirement withdrawals for widely divergent purposes such as buying a house and purchasing a personal computer. It is important to question if all these "needs" are related to security in old age since for many private sector employees, savings with the EPF may be the sole source of protection in old age.

Detailed data are only available for 1998 [EPF (1998)] but they throw light on the issue. Table 4 shows there were 9.2 million contributors (both active and inactive). Of this, less than half (42%) held balances of RM10,000 or above. One reason is that a sizeable number of contributors are from low- income groups. At the end of 1998, individuals earning below RM

[8] In 1987 the practice of computing dividends based on operating balance of each year was replaced by computations based on monthly balances.

TABLE 4. DISTRIBUTION OF CONTRIBUTORS' BALANCES, 1998

Balance (RM)	No. of Contributors (000)	%
Less than 1,000	1,990	21.7
1,000-1,999	743	8.1
2,000-2,999	524	6.7
3,000-3,999	422	4.6
4,000-9,999	1,642	17.9
10,000 & above	3,478	38.0
Zero/n.a	359	3.9
Total	9,158	100.0

Source: EPF 1998 Annual Report

1,000 per month accounted for 63% of active contributors and 24% of all balances. In contrast, those earning a monthly salary exceeding RM5,000 constituted only 3% of active contributors but accounted for nearly 22% of total balances. Another factor is that a big share of the contributors is young; in 1998, 57% of all contributors was aged 35 or below. Since the size of balance is positively correlated with age, the balances of young workers may be expected to increase with their age and earning power.

More revealing is that among those who held balances of RM10,000 or more, an overwhelming majority (87%) had balances that did not exceed RM50,000. In fact, 42% of the contributors held balances of RM20,000 or lower (Table 5).

TABLE 5. DISTRIBUTION OF CONTRIBUTORS' BALANCES ABOVE RM10,000, 1998

Size (RM000)	Contributors (000)	%	% of all Contributors
10-20	1,447	41.6	15.7
20-40	1,165	33.5	12.7
40-60	397	11.4	4.3
60-80	182	5.2	2.0
80-100	95	2.7	1.0
100-120	56		
120-150	48		
150-300	67	5.5	2.0
300-450	13		
Above 450	8		
Total	3,487	100.0	38.0

Source: EPF 1998 Annual Report

In general, average balances tend to drop significantly after age 50, primarily due to withdrawals in preparation for retirement. The average balance at retirement age (55 years) was only RM22,300 in 1997 (EPF, 1997). In 1998, it was reported that 81% of EPF contributors, aged 54, had balances of only RM30,000 or less [BNM (2000, p.22)] — hardly sufficient to support an individual, with no other source of wealth or protection, for a period of 14-19 years after retirement.

Table 6 shows the importance of various types of pre-retirement withdrawals for selected years between 1980-98. The rising magnitude of pre-retirement withdrawals is obvious, with withdrawals in "preparation for retirement" and for housing predominating. Pre-retirement withdrawals have averaged about 40% of all withdrawals since the 1980s and is the prime cause of the low average balances received on retirement. In fact, under current rules of pre-retirement withdrawals, up to 40% of the contributor's balance (or all of Accounts II and III) can be wiped out even before the retirement is reached!

TABLE 6. EPF: CATEGORIES OF PRE-RETIREMENT WITHDRAWALS (Selected Years)

Year	At Age 50 (%)	Purchasing House (%)	Housing Loan (%)	Medical Expenditures (%)	All Withdrawals (%)	All Withdrawals (RM million)
1980	23.6	3.4	–	–	27.0	203
1984	16.9	30.5	–	–	47.4	627
1989	14.4	45.0	0.4	–	59.8	1,584
1994	17.6	25.3	2.8	–	45.7	2,525
1998	15.0	12.1	16.4	0.2	43.7	8,549

Source: Compiled from Lee (2001: Table 2.3)

IV. *Returns on Investment*

With growing financial resources at its command, the EPF has emerged as a major investor in the domestic financial market, but the returns on its investments have been a subject of dissatisfaction. Thus, aside from low incomes and the increasing propensity to make pre-retirement withdrawals, poor dividend payments have been blamed for the small average balances held by contributors. An early Consumer Association of Penang (CAP) study estimated that contributors may have sacrificed interest earnings amounting to RM1.6 billion between 1970-84 (CAP, 1985) by foregoing investments in financial institutions. A more recent study concluded that the EPF's real dividend rate of 2.74% between 1971-1991 compared unfavourably to the estimated return of 4.26% from bank deposits and 5.6% earnings from equities during the same period [cited in Asher (2001, p.35)]. Such comparisons may not be strictly valid, however, since generating investment income is not the first priority of the Fund. Furthermore, the risk of saving with financial institutions is substantially greater than the low-risk associated with EPF savings. Also, interest earnings with financial institutions were often liable for income tax, while EPF dividends are not. Finally, all EPF contributions and withdrawals are exempt from income tax, subject to some conditions.

A more legitimate comparison is between the EPF and other conservative, government controlled funds. The *Tabung Haji*, for example, is a conservative Fund used by Muslims to set aside funds to finance their pilgrimage to Mecca. Its investments are restricted to *non-haram* (i.e. acceptable from an Islamic point of view) shares and activities. Despite these considerations, the *Tabung* paid nominal dividends averaging 12% between 1984-96. In 1995, it paid a dividend of 9.5% (up by half a per cent over the previous year) relative to the EPF's 7.5 per cent (down by half a per cent compared to the previous year). Another case is *Permodalan Nasional Berhad* (PNB); although, unlike the EPF, it operates strictly investment funds, it follows conservative investment strategies. Investment funds operated by PNB have returned average rates exceeding 13% in nominal terms. Naturally, returns from both the *Tabung* and PNB funds were substantially lower than the average 15% nominal rate paid out by companies traded on the Kuala Lumpur Stock Exchange during this period. But both have done considerably better than the EPF [cited from Kadir Jasin (1996, p.11)].

What accounts for this poorer performance of the EPF? The ability of the EPF to provide better returns rests on several factors interrelated factors. While the portfolio allocation and the investment strategy of the Fund merits reevaluation, the room for improvements is severely circumscribed by the statutory regulations imposed on the EPF. And, since the Fund is not allowed to invest in foreign capital markets, its investment options too are limited by the lack of depth and growth of the domestic financial and capital sector.

In terms of portfolio allocation, a statutory requirement obliges the EPF to hold at least 70% of its investment in "safe" but poorer paying Malaysian Government Securities (MGS). The Fund was therefore a major source of non-inflationary financing for the Federal government. However, with the decision to downsize the public sector in the 1990s and the consequent shortage MGS, its share in total investment has been declining (Table 7).[9] In 2000, investments had risen to RM179.0 billion, and only 35% (RM61.8 billion) was in MGS. Nevertheless, this represents a more than threefold increase in the MGS being held by the Fund.

TABLE 7. EPF: ALLOCATION OF INVESTMENT (Selected Years)

Asset	1984 RM million	%	2000 RM million	%
Malaysian Govt. Securities	17,184	84.8	61,766	34.5
Money Mkt. Instruments	975	4.8	36,674	23.1
Loans & Debentures	1,428	7.0	37,966	20.5
Equity	667	3.3	41,438	21.2
Property Mkt.	–	–	1,203	0.67
Total	20,256	100.0	17,9047	100.0

Source: EPF 1984 Annual Report & www.kwsp.gov.my

In the 1990s, with a greater freedom to diversify its portfolio, the Fund was faced with new constraints. The relatively undeveloped capital market, the volatility of returns in the stock market in the aftermath of the 1997 financial crisis, the pressures to err on the side of prudence, and the need to declare dividends that do not disappoint interest groups have all influenced the Fund.

Given the lack of supply of marketable securities, the Fund has increased the share of direct loans and debentures in its portfolio. Between 1984-2000, the share of loans and debentures rose from 7% to 21% of total investment. The increasing importance of loans reflects the fact that the Fund is assuming a larger role in financing private sector development, often at below competitive rates of interest. To illustrate, the mega public sector inspired but private sector executed Kuala Lumpur International Airport (KLIA) project received loans at

[9] Given the shortage of MGS, the statutory requirement has been waived annually by the Ministry of Finance [Thillainathan (2002)].

low interest rates. More controversial is the fact that the EPF provided funds below the market rates to privatized entities like the five independent power producers [Shaik Osman (1996, p.22)]. Thus, despite privatization and the downsizing of the public sector, the EPF continues to be used as a source of cheap funds.

Guided largely by the need to hold "safe" assets, the share of primary money market instruments (fixed deposits, money on call etc.) has also been on the rise. On the other hand, the Funds investments in the domestic equity have coincided with a period of unprecedented uncertainty and volatility, resulting in much lower dividend rates in the immediate past.

The EPF is therefore in serious need of a critical evaluation of its fundamental mission and how it has gone about achieving it.

V. *Reinventing the EPF*

The EPF should return to its core function of providing security in old age. It is doubtful if many of its contributors realize that pre-retirement withdrawals, while providing an immediate relief to their current cash-flow constraints, are eroding their meager protection in old age. Indeed, EPF publications that publicize these pre-retirement withdrawals as "added benefits being provided" do not mention this possibility at all.[10] Neither is it clear that contributors who approach the Fund for such withdrawals are properly counseled on its pros and cons. If all pre-retirement withdrawals are fully exhausted, a contributor will be left with only 60% of total contributions with the Fund on retirement. A 1998 study by the Life Insurance Association of Malaysia estimated that at the prevailing rate of total contribution (23%), such a contributor could expect to replace only 35% of the last drawn salary prior to retirement [LIAM (2002, p.F6)]. While there are banks that will provide loans to finance education and housing, albeit at some cost, there is no bank that finances old age. Efforts to reform and reorganize the EPF must pay attention to several key areas.

Minimizing Pre-Retirement Withdrawals

Bearing in mind the EPF's core function, it is legitimate to minimize the scope for pre-retirement withdrawals. Of the permitted pre-retirement withdrawals, withdrawals in "preparation for retirement" should be abolished since its real purpose has been outlived and end-use is not established.[11] The finance for housing, on the other hand, is a more important consideration. A house, apart from "providing a roof over the head," is also a hedge against inflation because it is an appreciating asset. But withdrawals for housing, unfortunately, erode funds set aside for retirement as well. To overcome this dilemma, it has been suggested that housing withdrawals be treated as a long-term, interest free loan which has to be repaid in monthly installments so that the contributor's balance is restored prior to retirement [Lee

[10] For example, a recent EPF sponsored column in a national newspaper highlights the use of funds from Account II for educational purposes without mentioning its costs in terms of protection foregone in old age. [See EPF (2002, p.F5)].

[11] This withdrawal was originally meant to purchase a house but was superseded by a specific scheme for the purpose. The original facility, however, has never been terminated.

(2001: Chp.2)].[12]

However, this suggestion is flawed in that it fails to address the issue of defaulters. Since the funds belong to the contributors in the first place, and borrowing has been done on the basis of financial need, what options are open to the Fund to recover these loans from defaulters?

Thillainathan (1997) believes that the EPF should continue to afford loans for housing because the forced nature of its savings might result in an under-consumption of lumpy investments like housing. He also questions the notion that the provision of housing finance by the EPF will undermine the old age savings accumulated by contributors; his simulation exercise suggests that the retirement fund could be quite substantial, even for low-income contributors, after providing finance for housing.[13] For example, a low-income contributor with a monthly salary of RM500 and obtaining a loan of RM30,000 to purchase a typical low-cost house costing RM35,000 would pay monthly installments of RM255. On retirement at age 55, he would have not only settled the loan but would have accumulated a retirement balance of RM186, 422! This is more than six times higher than the average balances held by retirees in reality.

The simulation assumes that no other form of pre-retirement withdrawals is permitted. It further assumes that the contributor purchases a house within his/her means and the timing of the purchase is such that there is sufficient time to restore balances prior to retirement. These assumptions are not always met in reality. Nevertheless, the exercise does suggest that an economically rational contributor could enjoy an interest free loan to finance housing without sacrificing provisions for old age protection.

However, the fact remains that withdrawals for *non-low cost housing* accounted for the largest share (ranging from 11-30%) of all withdrawals for 13 out of the 17 years during the 1982-98 period [Lee (2001, p.73-74)]. This, coupled with the low average balance of many contributors at retirement, suggests that the availability of interest-free EPF funds may have encouraged the purchase of houses beyond their means or requirements.

Another alternative is to allow EPF contributors in the private sector access to the low-interest housing loan facilities already open to government servants. The government housing loan scheme is supported from *general revenues* not contributions from government employees. Additionally, the scheme is already available to employees of government agencies, local authorities and statutory bodies who have opted for the EPF scheme. There is, therefore, sufficient justification for opening up the scheme since it only means making the facilities available to *all* EPF contributors. The advantages of this proposal are that it will confer an immediate benefit to EPF contributors, the bulk of whom are from lower income groups, without undermining their savings for old age. There is also a standard procedure already in place to ensure that the loans are serviced and defaulters are penalized.

The remaining two withdrawals from Account II pertain to higher education and computer purchase. With regard to the former, the cause of old age security is better served if the government sets up a loan fund from public revenues for the purpose. The study loan could be given out at low interest (or no interest) and be repaid by the students themselves

[12] He suggests doing the same for withdrawals pertaining to children's education and computer purchase, although he sees less justification for allowing these in the first place

[13] See Thillainathan (1997:140-145) for detailed computations and the assumptions made.

within a stipulated period after graduation. And even if such a scheme is not viable, there are banking institutions willing to offer study loans.

Withdrawal for the purchase of computers, on the other hand, deserves less sympathetic consideration and is best abolished. Malaysian schools and tertiary education institutions are rapidly being equipped with computer laboratories that provide students with access to the e-world.[14]

Another pre-retirement withdrawal allows payments for critical illnesses from Account III that hold 10% of total balances. While seemingly an important humanitarian concern, closer scrutiny suggests that, in most cases, the resources would be inadequate to meet the cost of critical illnesses. For most contributors Account III holds only 10% of a *small total balance*. Additionally, many health problems arise well after age 55 when the Fund offers no support. A better alternative would be for the EPF (in cooperation with insurance companies) to devise a compulsory health insurance scheme for contributors [Lee (2001); Thillainathan (2002)]. Compulsory participation will keep premiums low and the scheme could be designed for healthcare over a longer time span (say, until age 70 or 75).

On another front, the degree of old age support afforded by accumulated balances can be extended if withdrawals are spread out over a longer time period (akin to an annuity). Such facilities already exist but they are optional. Lump sum withdrawals remain popular and the EPF Board Chairman noted recently that 72% of contributors who withdrew their balances on retirement (at age 55) spent it all within just three years (*Star*, Jan. 22, 2002). Hence, there have been calls to abolish the lump-sum withdrawal facility. However, abolishing lump sum withdrawals not only violates the right of the contributor to decide how the savings are collected, but also presumes that the Fund can better anticipate the welfare of contributors. A more preferable approach would be to educate contributors on the dangers of carelessly spending lump sum withdrawals.

Finally, preserving the adequacy of balances with the EPF requires some form of indexation to provide a minimum level of protection against inflation.

Revamping the Investment Strategy

The investment performance of the EPF deserves serious consideration as well. In the short term, if the EPF is continuously relied upon as cheap source of funding for government projects and "priority" projects undertaken by the private sector, contributors cannot expect competitive returns on their balances. If this practice is retained, the EPF must be given special consideration for the subsidy it provides in the name of national interests. It has been suggested, correctly, that the Ministry of Finance and the Ministry of International Trade and Industry accord the EPF special status and allocate it a quota of all public issues and offers for sale of shares of companies seeking a listing in the Kuala Lumpur Stock Exchange. Such special allocations are already made to priority institutions such as *Permodalan Nasional Bhd*[15] [Shaik Osman (1996, p.22)].

These suggestions aside, a more fundamental reform would involve allowing the EPF to

[14] This facility was discontinued recently (mid-2002) due to widespread abuse.

[15] The PNB is given priority because it is an investment vehicle used to enlarge the participation of indigenous *Bumiputera* in the corporate sector.

make its own investment decisions, free from politically motivated or other subsidiary considerations. The need to strengthen the EPF's independent investment management expertise is underscored by another potential challenge. Asher (2001, p.31) points out that if the 1989-99 compound rate of growth is maintained, EPF balances will reach RM1,000 billion within the next twenty years. The domestic financial and capital market not only lacks the depth to absorb such huge amounts of funds, but the EPF itself may be short of the expertise to manage them.

In a thoughtful article, Thillainathan (2002) discusses at length the changes in portfolio allocation and investment strategy required to optimize the returns from the Fund's investments.[16] He argues that in order to improve its returns in the long-run, the EPF must diversify its portfolio to include a greater share of equity investments. In view of the limited availability of viable equities domestically, the EPF should be allowed to invest some part of its funds globally. He cites a Goldman Sachs study covering the period 1985-94 that suggests that if EPF investments in MGS had been reduced to 75% and investments in equities and properties had been increased to 10% and 5%, respectively, the average returns on this more diversified portfolio would have been 15% higher, with a corresponding reduction in risk of about 12%. The study further suggests that if the EPF had invested up to 30% in global equities and global bonds, its returns would have increased by 25%, and reduced its risk by one-third from the results achieved from having the funds wholly invested in Malaysian assets.

Two implications follow with these suggestions. First, the increased returns can only be seen in the long-term (in 10-20 years) since they will be primarily in the form of capital gains. Second, a greater exposure to equities will mean greater volatility and this would be reflected in unstable annual dividends. Both contributors and their lobbyists alike (like the trade union groups and non-governmental organizations) will find fluctuating dividends difficult to accept (as evidenced by recent experience). The EPF has historically declared dividends that have been insulated from market volatility because of its large holdings of MGS. Thus a major shift in portfolio structure must be accompanied by concerted efforts to educate the contributors and groups that protect their interests.

The Fund should also adopt a passive management stance for the bulk of its investments. This means that it will avoid the largely futile exercise of trying to predict bullish and bearish trends in the markets in the hope of maximizing short-term gains. A passive management approach also ensures that short-term returns reflect market fluctuations rather management judgements. Additionally, the potential to realize long-term gains is not compromised.

A passive strategy recommends itself on two other considerations as well. The Fund effectively lacks the expertise to attempt a more aggressive strategy. Also, if the EPF does not unload rising stocks and hoard losing stocks, it will lend stability to domestic capital market and contribute positively to its development.

Finally, given that the age profile of contributors vary, they have different capacities to bear risk (as measured by asset price volatility). In general, the young having a greater capacity to bear risk, relative to older contributors nearing retirement age. The current investment strategy of the Fund does not capitalize on these differences. In order to do so, the Fund has been urged to develop three separate investment plans to cater for the young, the middle-aged and the older contributors. In this way, each group can have investments with

[16] The section that follows draws, with permission, on his paper.

risks broadly appropriate with their risk-bearing capacities. And rather than mandating that each group participate in the plan appropriate for them, the choice should be left open to the contributors themselves, after they are briefed on the risks and gains associated with each plan.

The three plans will allow different styles of management. Funds of the younger group allow for an active management style and thus could be contracted out to external fund managers with proven expertise. The plan involving older contributors, on the other hand, could be managed on a passive basis in-house.

If the Fund persists in maintaining the three Accounts and their respective purposes for withdrawals, the plan above must not only take account of the age of contributors but will be restricted to Account I, which acts purely as a retirement account. Funds in Accounts II and III are subject to frequent withdrawals and will have to be kept in more liquid assets.

It is envisioned that the reinvented EPF, unlike the present one, will offer investment choices to contributors, on a competitive basis. The contributor will be able to choose between asset classes, investing locally or abroad, active or passive management styles and different providers of annuity products. The contributor would therefore be free to make these choices based on individual evaluations of expected return and risk, risk preferences and risk-bearing capacity. However, this assumes considerable investment savvy among the average contributor — which might be an over expectation. Consequently, the Fund would also have to upgrade its investment advisory capacity to serve its contributors more fully.

VI. *Conclusion*

Despite the impressive developments in the EPF from its humble beginnings in 1951, the reality remains that the EPF is unable to provide sufficient protection to most of its contributors. Consequently, apart from specific measures to address some inherent weakness in these schemes, supplementary measures outside the EPF structure are also needed. Increasing the retirement age from the present 56 to, say 65, for example, would shorten the post-retirement period and extend the period to accumulate savings. Additionally, well-designed, low premium annuity schemes to suit different levels of desired adequacy could supplement the protection afforded by the EPF. However, alternative private pension insurance plans are "almost non-existent in Malaysia" because the perceived security afforded by the EPF, and the expectation that the children will provide support in old age have dampened the demand for them. On the supply side, the lack of a solid fixed income long-term capital market, and an active secondary bond market has made insurers reluctant to launch pension plans at competitive rates [BNM (2000, pp.21-24)]. All this calls for a vigorous plan of action that combines educating the public, offering them professional advice, offering attractive incentives, on the one hand, and concerted actions to develop the local capital market, on the other.

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