Malaysian Pension System – the Gaps and the Need for Pension Reform

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19 November 2021

This paper presents an argument for a structural reform of the Malaysian pension system that is necessitated by gaps in the system (or "pension gaps") in the form of insufficient funding, inadequate savings and inadequate coverage. These pension gaps, if not addressed, will in the long-term impact upon the economic well-being of future generations of working population and create poverty among the elderly population.

Introduction

The Employees Provident Fund (EPF) operates a fully funded retirement plan whereby employers and employees in the private sector contribute a percentage of the employees' remuneration into the employees' retirement savings account opened with the EPF. The EPF will invest these contributions to generate returns to increase the size of the employees' retirement savings. Upon retirement, employees are paid lump-sum equal to the balance accrued in their retirement accounts. Therefore, the size of an EPF member's retirement benefit is determined by his/her contribution over the years and the returns generated by the EPF.

On the other hand, the Government operates a pay-as-you-go (PAYG) pension scheme for the public sector employees. The scheme promises a defined benefit pension payable over the lifetime of the pensioner. In contrast with the EPF system, the quantum of the public sector pension is determined as a fraction of the pensioner's last drawn basic salary and the total number of months of pensionable service rendered, and is not directly dependent on contributions and investment returns. Another point of contrast with the EPF is that, under the PAYG arrangement, pension payments are being made from the Government's current revenues and not through savings of the pensionable employees as the pension scheme is non-contributory. Nevertheless, the Government had started a program to pre-fund the public sector pension "promise" with the establishment of Retirement Trust Fund (KWAP) in 2007.

Pension Gaps

The first pension gap in the Malaysian pension system is the vulnerability of the PAYG scheme to demographic changes in the form of a fast-ageing Malaysian population. In 2020, 7.0% of population are above the age of 64; by 2040 or 18 years from today, this is projected to reach 14.5% of the population. Whereas in 2020 there were 10 working-age individuals supporting every 1 elderly person, by 2040 this ratio will be down to 5 workers to 1 elderly person. Since the pension benefits of PAYG scheme are paid from collection from the current working population, the pension burden borne by Malaysia's future generation is on-course to double by 2040. In terms of the public sector pension scheme, there is a need to ensure that pensioners of the future will be less dependent on the support of the future working population through an appropriate and adequate funding policy.

The second pension gap is that the current EPF members' savings are inadequate. In 2020, only half of the EPF's 14 million members are active, even with a very lenient definition of active member as one who has made at least one contribution to his/her EPF account in the last 12 consecutive months. Unsurprisingly, in 2020, the 257,000 EPF members aged 54 years old had a median saving of only RM140,000. Such balances are expected to provide a monthly income of a mere RM583 over 20 years from retirement at age 55, which is significantly lower than the current poverty line of RM2,208. Therefore, as cost of living and healthcare increase, the issue of poverty in old age is expected to become more widespread and more acute in intensity in Malaysia.

The COVID-19 pandemic only exacerbated the issue of inadequate savings. To cope with the lockdowns, the EPF introduced special pre-retirement withdrawal facilities which saw the disbursement of RM101 billion to over 7.4 million members, or about half its total members. However, these have left 73% of members without adequate funds to retire comfortably, with 6.1 million members now having savings of less than RM10,000, of whom 3.6 million have less than RM1,000. The EPF estimates that members will need to work an extra four to six years to rebuild savings that have been withdrawn during the lockdown.
The impact of the COVID-19 was also to skew the distribution of savings further as the bottom 40% (B40) of EPF members (about 5.0 million members) saw their savings drop by 38% to a median balance of RM1,005. The middle 40% (M40) also saw their savings decline 18% to a median of RM24,995. The top 20%, on the other hand, saw an increase in savings but only to a median of RM152,043.

The third pension gap is the non-coverage of self-employed and informal sector workers. It is estimated that self-employed and informal sector workers make up about 60% of the 23 million working age population in Malaysia. The current system allows them to make voluntary contribution to the EPF with a special incentive contribution by the Government of up to RM250 a year. Despite this incentive, however, the participation in the EPF of self-employed and informal sector workers remains very low.

The pension gaps described above is not unique to Malaysia – it is fairly common among countries experiencing an ageing population and those with a low income or a much skewed income distribution. Nor is the problem only recently identified, although the EPF has not undergone a structural reform since it was established in 1951. A few measures have been proposed before to address these issues, but they have their limitations and can bring about unintended consequences.

Addressing the Gaps

Among commonly proposed measures to address the pension gaps is to increase retirement age which serves to postpone withdrawals from pension funds and give more time to workers to build up their retirement savings. However, this measure only provides temporary relief if the population continues to age and the experience of other countries indicates that it is also unpopular. An unintended consequence that has to be evaluated is whether keeping older workers in their posts will impede the entrance of new workers into formal employment.

Another commonly proposed measure is to increase the contribution rate to the EPF in order to increase workers' savings. However, the current mandatory contribution rate of 23% to 24% of salary is already the fifth highest in the world. Increasing the contribution rate any more will increase the cost of hiring workers and/or reduce workers' take-home pay. The unintended consequence may be to discourage direct foreign investment to set up operation in Malaysia and to discourage employers from hiring permanent workers.

One measure that can increase retirement savings without having to increase the contribution rate is to restrict pre-retirement lifestyle withdrawals. Some thirty percent of EPF contribution is deposited in EPF Account 2, from which members may withdraw funds pre-retirement to pay for housing, medical, education and other expenses. It is necessary to limit these leakages to protect retirement savings. However, one form of Account 2 withdrawal that could be permitted is for the purchase of life/critical illness/medical insurance policy. This exception is based on the social protection value offered by such policies which enhances that offered by the EPF.

With regard to the B40 and M40 groups, in particular, one suggestion that has been proposed to help increase their retirement savings is to have tiered dividend rates whereby the EPF will pay higher dividends to those with smaller savings. However, this may prove to be unpopular as it can be perceived to be unfair to those who contribute more into the EPF system.

To help Malaysians save more for retirement, the Private Retirement System (PRS) was introduced in 2012, designed as a third-pillar pension provision to supplement the second-pillar EPF. Having a multi-pillar pension system is consistent with the pension framework recommended by the World Bank and the Organisation of Economic Co-operation and Development (OECD). However, despite the tax incentive provided to those who participate in the PRS scheme and the potentially higher investment returns, the number of participants in the PRS by end-2019 was approximately half a million (in comparison, the EPF has 14 million members) with an average fund value of RM10,000 per participant. In an environment where the country is already having a high savings rate (in the form of the EPF contribution), the creation of another retirement savings platform is having a challenging time attracting additional savings. Therefore, a pension reform such as coupling the tiered EPF dividend rates with a salary cap on EPF contribution could encourage high-income earners to channel their excess savings into the PRS, as well as to increase the retirement savings of the B40 and M40 groups.

To enhance the post-retirement protection offered by the EPF, one improvement that can be implemented in the long-term is the creation of a national annuity fund linked to the EPF. Ideally, once a member's savings has reached a high-enough level, an amount is transferred to the annuity fund that pays a monthly pension. The purpose is to gradually move away from lump-sum payments and stagger the withdrawal of retirement savings such that the balance continues to generate returns thus income for the pensioner is extended for as long as possible.

Conclusions

Measures to address the pension gaps must lead to the following: an increase in pension coverage, a healthy ratio of young-to-elderly members, an increase in savings at retirement especially for the B40 and M40 groups, a more staggered withdrawal of retirement savings perhaps in the form of annuity and greater roles played through a third pillar pension provision.

As with all areas of public policy, the challenges are numerous and barriers to change are high; and it is practically impossible to implement all desired reforms at once. The nature of pension systems is such that problems have a long lead time to manifest themselves. Therefore, serious problems that can destabilize the system and impact upon large sections of society do not appear grave while they are still manageable. However, it is also the nature of pension systems that the outcome of reforms does not manifest themselves until 30 to 40 years after implementation. Therefore, it is necessary to be proactive and continuously review, assess and take small steps over time to ensure affordability, adequacy and sustainability of the pension system, to meet the needs of today's retirees and afford the promises we are making to today's workers.

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