

Public Pension Funds

The slow pace of pension reforms continues to be of concern. In particular, the short-term financial condition of the Social Security System (SSS) remains problematic despite measures taken in the past couple of years to curb the drainage. Problems at the Government Service Insurance System (GSIS) continue to be centered on its deficient administration and poor pension fund investment results while the Armed Forces of the Philippines Retirement and Separation Benefits System (AFP-RSBS) is in need of a major overhaul according to the results of the Feliciano Fact-Finding Commission Report. The suggested areas for the Government to focus on include: (i) accelerating parametric changes at SSS to narrow the gap between contributions and benefits; (ii) improving GSIS administration capacity and its pension fund investments; (iii) taking stock of the AFP-RSBS assets and liabilities; and (iv) improving investments and oversight of pension funds in general.

Background

The retirement income system in the Philippines consists of four layers. The first layer, at its base, supports the poorest Filipinos through the programs of the Department of Health, the Department of Social Development and Welfare, and the Philippine Health Insurance Commission. The second layer includes the mandatory, publicly managed Social Security System (SSS), which covers most private sector employees, and the Government Service Insurance System (GSIS), which covers public sector employees. Some government officials, though, such as those in the Armed Forces of the Philippines, are covered by a separate system, the Retirement and Separation Benefits System (AFP-RSBS).

The third layer includes mandatory deposits maintained at the Home Development Mutual Fund (Pag-IBIG) set up to provide housing funds and to encourage long term savings and, for workers in the private sector, the mandatory retirement pay provided under RA 7641 (and in some cases funded through voluntary occupational pension plans operated by private employers). The fourth layer consists of a range of individual contractual savings

instruments including pre-need plans,¹ life insurance, and employer-sponsored provident funds. Taken together, these four layers provide a foundation for building an effective retirement income system. However, a number of adjustments will be needed in their individual operations as well as in their interactions before a fully integrated system can be implemented. In particular changes are necessary to assure the financial viability of the system, fair treatment of all participants, and improved performance.

The Government has recognized the need for reform for several years and has taken some initial steps to improve the retirement income system, including the Social Security Act of 1997 (RA 8282) and the Government Service Insurance System Act of 1997 (RA 8291).

Further changes have since been introduced, particularly at SSS (see below), but there is still a long way to go to ensure the collective long-term financial sustainability of SSS, GSIS and AFP-RSBS.

¹ Contracts that provide for the performance of future services or the payment of future monetary considerations at the time of actual need, for which plan holders pay in cash or installment at stated prices, with or without interest or insurance coverage. They include life, pension, education, and funeral plans.

B. Issues and Suggestions

Rebuilding the financial sustainability of SSS.

The financial condition of SSS continues to deteriorate. The audited financial statements for 2002 show actual benefit payouts exceeding actual contributions by almost P7 billion (US\$125 million equivalent).² The deficit has been paid out from the pension fund reserve, thus reducing the life expectancy of the fund.

While the actuarial valuation carried out in 1999 showed a possible depletion of the pension fund by 2015 (if no immediate actions are taken to improve the financial and actuarial position of the reserve fund), more recent estimates made in 2003 by the SSS actuary indicate that SSS faces a depletion of its assets by 2014 in the absence of further corrective measures. This recent revelation highlights a significant contingent liability for the Government, which implies that there will be additional pressure on the consolidated public sector deficit from a source that has traditionally been in surplus.

Since January 2002, SSS has adopted a number of measures that have had a positive impact on its operational performance and short-term liquidity. The measures include:

- Increasing the maximum monthly salary credit from P12,000 to P15,000 as of January 2002.
- Changing the definition of Credited Years of Service beginning January 2002 by increasing the actual number of months of contributions required to account for a year of contributions from six to twelve months.

² Analysis of the reserve fund of SSS shows that benefit payments exceeded contributions in 1993 to 1995 and in 1999 to 2002, resulting in a decrease in the expected life of the reserve fund. The latest increase in the monthly contribution rate, prior to the 1% increase that went into effect on March 1, 2003, was in 1979. Benefits to members, however, have increased annually since 1980.

- Reducing operating costs by 8 percent since 2001, bringing operating costs close to the 12 percent mandatory level.
- Tightening disability rules by revising the Disability Assessment Manual and implementation of the new SSS Disability Program.
- Tightening investment guidelines to strengthen portfolio management. While no resources are diverted to fund housing or other development projects, investment guidelines are not yet fully consistent with the principles of safety, liquidity, and yield as mandated under SSS law.
- Increasing contributions by one percentage point, from 8.4 percent to 9.4 percent, starting March 1, 2003.

As mentioned earlier, the latest analysis indicates that unless further changes are made, SSS funds will be depleted by 2015. However, this could well happen sooner as the majority of SSS investments are kept at book value and not at market value, so this actuarial analysis does not take account of the impact of declines in the value of real estate and equity holdings since the 1997-98 Asian crisis. . On balance, the negative impact of these declines in value basically offsets the positive impact of the above measures. Analysis undertaken in recent months, indicate that adjustments investment valuations to being them close to market value reduces the life of the SSS fund by at least four years, i.e., to 2011. However, incorporating the impact of the reforms listed above extends the life of the fund by three years, to 2014.

Hence the contingent liability to the Government remains large, with the gap between contributions and payouts growing over time, despite the measures introduced since 2002. A strategy for improving the viability of the fund would include measures to:

- Improve collections from employers and employees.

- Accelerate recovery of nonperforming loans from members and the National Home Mortgage Finance Corporation
- Progressively adjust the pension formula to contain the growth of payouts.
- Gradually increase contribution rates for employers and employees, as well as the minimum monthly salary contribution until the life of the fund is adequately extended.

These short- to medium-term measures are needed and should be accompanied by a more comprehensive reform to ensure the long-term sustainability of the SSS. Such a comprehensive reform is likely to take three to four years (at the minimum) as it requires consensus building and approval from several government agencies and Congress, making it essential for the Government to start the reform process as soon as possible and, ideally, in tandem with the short- and medium-term measures described above.

Strengthening GSIS administration and investment portfolio.

While in the past few years the SSS has been suffering from a depletion of reserves, GSIS is facing a completely different problem: excess liquidity and not enough investment instruments that will provide the required returns to maintain the equilibrium of the pension fund.

In 1993, GSIS reported excess liquidity in the amount of P30 billion (10% of total reserves or US\$375 million equivalent). The pension fund continued growing but investment income was constrained given the lack of local investment instruments and the continued deterioration of the stock and real estate markets.

In this situation, GSIS undertook measures that have had implications on the performance of its portfolio and the long-term sustainability of the fund. While their impact may not be felt in the short term given the excess liquidity at GSIS today, all these actions will have a severe impact in

the future and may derail any initiative to implement comprehensive pension reform in the Philippines. Many of these actions are helping to widen the already marked difference between contributions and benefits and will put a considerable burden on the future actuarial sustainability and financial viability of the pension system.

Without a centralized information system to manage data and individual records, it is difficult to ensure the timely posting of contributions and loan payments. GSIS's management lacks the information needed for monitoring the day-to-day operations and to make timely decisions (e.g., portfolio performance, administrative expenses). At the same time, given the lack of data, GSIS is unable to produce the required information to determine the actuarial and financial situation of the pension fund or to use tools such as the Pension Reform Options Simulation Toolkit, even after the World Bank trained several GSIS staff and provided the required software.

While GSIS has started to take actions to improve its administration, the results have not yet materialized. Delays in processing contributions, loan requests, and payments have infuriated beneficiaries. As a result, the Government has taken action this year, requesting GSIS to grant loans without verification of past repayment history and increasing the ceilings for the different types of loans, without properly assessing the future financial implications of such decisions. Meanwhile steps that GSIS undertook to improve administration included:

- attempts to update its loan administration systems to facilitate loan applications and accelerate posting of loan payments;
- attempts to update its database on pensioners;
- attempts to update service records and payments;

- attempts to implement electronic remittances of contributions from all government agencies;
- plans for introducing a cross-default policy³ to reduce the number of nonperforming loans; and
- steps to integrate information from all GSIS branches.

To coordinate and automate these activities, GSIS has started integrating and expanding its information systems. Despite a good start in early 2003 with strict deadlines for the completion of the different modules, mounting problems were encountered that caused the collapse of the system and a slowdown in operations. By June 2003, GSIS was forced to suspend the extension of new loans to its members and only a reduced number of claims were processed. Until the recent government intervention, the GSIS was only paying pensions and devoting all its efforts to reestablishing the system for recording contributions and loan repayments.

To improve the GSIS situation the following actions need to be implemented in the short to medium term:

- Settle past-due contribution payments from the Department of Budget and Management;
- Improve pension administration through a stronger and more coherent information technology platform, including developing and implementing a data warehouse and management information system.
- Improve investment performance (managing diversification, yield and

³ The cross-default policy means that GSIS was supposed to check that members that have loans which are past due will not be granted additional loans and their pensions and/or other benefits will not be paid. While a good idea in theory, the Government had in practice pressured GSIS to not only provide loans (regardless of the status of other loans) but also requested GSIS to increase the amounts for different types of loans.

risk) by outsourcing the investment of parts of its portfolio to professional pension fund managers and, if possible, investing a percentage of their funds abroad.

- Revamp pension fund management through better information technology, processes, and staff training.
- Review investment guidelines to ensure that they are congruent with best practices worldwide.
- Properly value assets to determine the sufficiency of the assets to meet future liabilities.

Rebuilding pension provisions for the armed forces (AFP-RSBS).

SSS and GSIS do not apply to Armed Forces of the Philippines personnel, who are covered under the retirement system as contained in Republic Act (RA) 340 and amended by Presidential Decree 1638 in 1979, known as the AFP Military Personnel Retirement & Separation Law. AFP-RSBS retirement provisions are generous compared to that of the GSIS and SSS members. However, as there has never been any form of advance funding of active members' accruing benefits, these benefits are paid to retired members through government appropriations. This liability is increasing and constitutes a growing portion of the defense budget, thus crowding out critical defense expenditures.

In recent months, the Feliciano Fact-Finding Commission Report dated October 17, 2003, has recommended the closure of the AFP-RSBS and calls for the liquidation of its assets, the return of members contribution and the establishment of a new agency similar to that of the GSIS.

The risk with such an approach is that the same mistakes made when AFP-RSBS was established could easily be made again. Moreover, there is no comprehensive list and the demographics of active and retired

personnel and little is known about the real value of the assets held by AFP-RSBS. Without this information it is not possible to know what the fiscal cost of the closure of AFP-RSBS will be and how to formulate a new pension plan that is fair to all and financially sustainable.

Taking into account the foregoing situation, the Board of Trustees of the AFP-RSBS mandated the creation of a Legislative Reform Office (LRO) to identify and recommend options that will ensure the long-term viability and sustainability of the military retirement system and to rationalize the role of the APF-RSBS. During the past year, LRO has conducted extensive research on different social security and retirement systems and it has conducted consultation sessions with its stakeholder-members. However, there are key activities that have yet to be undertaken to ensure that the best possible reform options are identified. Only when there is a demographic profile of the military, an actuarial valuation and information on the fair market value of the assets of RSBS will the true situation of the AFP-RSBS be understood, the cost of its closure or reform known and the design of a more equitable and sustainable system possible.

Strengthening Department of Finance (DOF) oversight

From DOF's perspective, pension reform should continue to be at the top of its agenda. A reform of the national pension system is time consuming and costly but should be started before associated contingent liabilities rise further.

As the government's fiscal manager, DOF has a strong interest in the reform of the pension system. Any problems that threaten the long-term solvency of these institutions will translate into a fiscal problem for DOF.

In order to properly carry out its responsibilities to monitor GSIS and SSS, DOF needs to strengthen the Corporate Affairs Group Monitoring Unit and perhaps

appoint an independent regulatory agency to oversee the operation of the pension funds. The recent announcement that the Insurance Commission will now be responsible for the oversight of the GSIS and SSS, a move aimed at instilling transparency in the operations of the two pension funds and therefore protecting their members' interests, is a step in the right direction.

In addition, DOF should take more proactive measures to:

- establish pension fund prudential rules and investment guidelines that can facilitate outsourcing of investments to pension fund managers and facilitate investment in foreign securities.
- Train staff, to improve the supervision and auditing of pension funds.