Voluntary Pension System (VPS)

A Concise Guide for Investors

This concise guide explains how a Voluntary Pension System (VPS) works and factors to consider when investing in VPS schemes. We recommend that you use the services of a pension fund manager to guide you. Please also visit SECP's investor education portal at www.Jamapunji.pk to learn about VPS and investing in general.

Disclaimer

All investments in the pension funds authorized under the Voluntary Pension System Rules, 2005 are subject to market risks. The value of investments as reflected in the net asset value (NAV) of units of a pension fund may decrease as well as increase, subject to market fluctuations and risks inherent in such investments. In addition, changes in tax laws can impact your benefits. Past performance does not necessarily predict future results.

The Securities and Exchange Commission of Pakistan (SECP) or the pension fund managers do not guarantee the benefits or profits to the participants, under any circumstances whatsoever. Participants should read the offering documents carefully to understand the investment policies, risks and tax implications of the respective pension funds, and should consult with financial, legal and investment advisors before making any investment decision.

While every effort has been made to ensure that information in this publication is accurate, it is made clear that this is not a legal document. This guide is not meant to be exhaustive and only the most important issues have been discussed. While every effort is made to ensure accuracy and completeness of information contained in this guide, the Commission makes no guarantee and assumes no liability for any errors or omissions of the information. No one can use the information for any claim, demand or cause of action.

Contents

1. The need for retirement planning

Most developed countries have retirement systems sponsored by employers and/or state that are funded during an individual's working life to pay pensions on retirement. In Pakistan because of lack of funding, we do not have a viable social security system. Support for the old is mainly provided through the family, and is generally not sufficient.

Retirement is the point where a person stops employment completely. A person may also semi-retire by reducing work hours. It is a phase of life where your sources of income stop or decrease, but your expenses remain the same. We refer to income received during retirement as pension income.

We would like to think of retirement as the part of our life where we can appreciate life and the beauty of the world around us. Unfortunately for most individuals, who have not planned for their retirement, it is a stage of life dominated by:

- Limited income;
- Healthcare issues;
- Dependency on children;
- Difficulty in meeting expenses;
- Sacrifices and hardships; and
- No enjoyment.

For most retiring individuals, without adequate income during retirement, living on handouts from family members can be both challenging and humiliating. Accordingly, to maintain your independence and life style, it is important that you plan your retirement at an early age, so that you may have the pension income to pay for your expenses in old age.

2. Types of pension schemes

Pension schemes differ in terms of how they are funded. These include:

- Defined Benefit: This provides entitlement to a "fixed benefit" usually a proportion of salary in the last few years before retirement. The investment risk lies entirely with the employer/ scheme sponsor.
- Defined Contribution: Benefits paid out of the scheme are directly related to the contributions made, and the returns earned on those investments during the pre-retirement period. An annuity or draw-down scheme is required on retirement. The investment risk lies entirely with the scheme beneficiary.

3. Pension fund alternatives in Pakistan

In Pakistan there is some coverage through retirement benefit schemes which focus on lump sums such as provident and gratuity schemes. The utility of lump sum benefit systems is limited, as they pass on the responsibility for managing funds and risks of longevity to the retirees. Pension schemes exist but primarily in the public sector including government and multinationals.

Private Citizens mainly depend on:

- The next generation to support them in their old age;
- Income from property; and
- Interest on bank deposits

To enable individuals to provide for their retirement by investing for the long term in a regulated environment, the Voluntary Pension System (VPS) was introduced by the Securities and Exchange Commission of Pakistan (SECP).

4. Voluntary Pension System (VPS)

The Voluntary Pension System (VPS) is a tax advantaged, self-contributory defined contribution pension scheme open to all individuals having a valid National Tax Number or a Computerized National Identity Card (**CNIC**) or National Identity Card for Overseas Pakistanis (NICOP) or Pakistan Origin Card (POC). It has been established under the Voluntary Pension System Rules, 2005 under which employed and self-employed individuals can voluntarily contribute to a pension fund during their working life to provide regular income after retirement.

It is important to note that a defined contribution plan does not promise a specific amount of benefit at retirement. Under this plan, the employee or the employer (or both) contribute to the employee's individual pension account (IPA) which is invested for the long term. The funds accumulated are used for payment of a regular pension or lump sum on retirement.

The Voluntary Pension System (VPS) is regulated by the SECP, which entails:

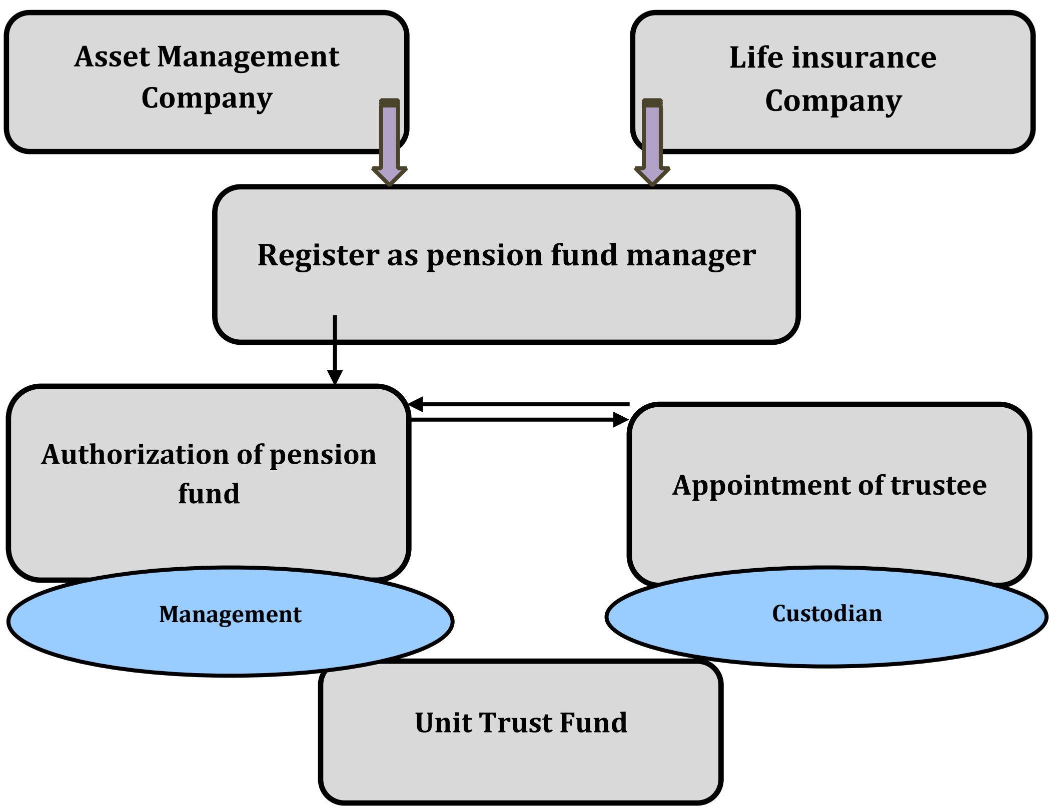
- Registration of pension fund managers
- Authorizing pension funds
- Prescribing investment and allocation policy for pension funds
- Monitoring and supervision of pension funds and protecting the interests of pension fund account holders through enforcement

5. Structure of Voluntary Pension System (VPS)

To protect pension fund account holders, a VPS separates fund management and custody of funds through the establishment of a trust. Asset management companies (AMCs) and life insurance companies, meeting the fit and proper criteria, and regulatory requirements as laid down by the SECP may register to act as pension fund managers (PFMs).

Constitutive document, trust deed and offering document of the pension fund are approved by the Commission, before allowing the fund manager to invite the participants to contribute to their individual pension accounts (IPAs). The SECP has specified an investment and allocation policy for pension funds setting out the broad parameters for investment of contributions received.

The structure of a Voluntary Pension System is illustrated below.



6. Regulatory framework

The VPS is governed by the following laws:

- Voluntary Pension System Rules, 2005;
- Non-Banking Finance Companies and Notified Entities Regulations, 2008 and

- SECP Circulars& Directives

Other applicable laws include:

- Income Tax Ordinance, 2001; and
- Trust Act, 1882.

The pension fund managers, pension funds and trustees are subject to monitoring by the SECP.

7. Characteristics of Voluntary Pension System (VPS)

Some of the unique characteristics of VPS include:

- **Long term investment horizon:** Investment strategy is based on the long term to enable fund managers to ride the ups and downs of the market and to balance the portfolio keeping in view the participant's age and risk profile.
- **Security:** the VPS separates fund management and custody of funds through the establishment of a trust with an independent trustee.
- **Diversification:** Voluntary Pension Rules 2005 allow investment in up to 5 sub-funds, i.e. equity, equity index, debt, money market, and commodity market sub-funds. Allocation Schemes are designed to protect investors by offering a mix of the sub-funds based on investment horizon and risk appetite. Conventional and Islamic options are available.
- **Disciplined savings:** VPS promotes disciplined savings through contributions that may be matched by some employers. No penalty on missing any payment. Participants can define their own investment plan through choice of asset allocation based on their age, risk tolerance and return expectation.
- **Tax benefits:** At contribution stage annual tax credit on up to 20% of annual taxable income; on retirement, you can receive 50% of lump sum amount tax free, remaining balance (or entire balance) can be invested in an income payment plan or annuity.
- **Professional fund management:** Pension funds are managed by asset management companies (AMCs) and/or life insurance companies with proven past experience and the ability to diversify and balance a portfolio keeping in view an investors risk tolerance and age.

8. Stages in Voluntary Pension System (VPS)

There are three stages in accumulating retirement funds through the Voluntary Pension System. These are: contribution, investment and retirement, respectively.

9. Contribution stage

Important: *The only way to build enough funds for your retirement is to start contributing to your pension account as soon as you start working. You must make a commitment to contribute regularly to your pension account through salary reduction, if you are an employee, or individually if you are self-employed.*

The following should be noted about the contribution stage:

- All individuals having a valid National Tax Number or a Computerized National Identity Card (CNIC) or National Identity Card for Overseas Pakistanis (NICOP) or Pakistan Origin Card (POC) are eligible to participate. Contributions can be made by individuals as well as employers on behalf of their employees.
- Contribution can be in lump sum or at regular frequency. There is no penalty on missing any payment.
- The pension fund manager shall open and maintain an individual pension account (IPA) in the name of each Individual (referred to as a “Participant”) for making contributions. Each individual pension account (IPA) is assigned a unique identification number (UIN).
- All contributions made by an individual are immediately credited to their IPA and used to purchase the units of the sub-funds according to the allocation scheme selected by the individual.
- At contribution stage annual tax credit of up to 20% is allowed as specified in Section 63 of the Income Tax Ordinance, 2001.

Under the VPS rules 2005, a pension fund may offer the following four sub funds for investment of contributions:

i. Equity sub-fund: specializing in listed securities;

ii. Equity Index sub-fund: specializing in tracking index of listed securities;

iii. Debt market sub-fund: specializing in long-term debt securities;

iv. Money market sub-fund: specializing in short-term debt securities and other money market Instruments; and

v. Commodity sub-fund: specializing in commodities’ future contracts traded on the Pakistan Mercantile Exchange (PMEX).

It may be noted that a majority of the pension fund managers are offering investment opportunities in only three sub-funds, namely equity, debt and money market respectively.

10. Investment stage

Important: The following should be noted:

- The value of investments as reflected in the net asset value (NAV) of units of a pension fund may decrease as well as increase, subject to market fluctuations and risks inherent in such investments. Past *performance does not necessarily predict future results*.
- *The key to accumulating enough funds for your retirement is to keep a long-term investment horizon. This will allow you to ride the ups and downs of the market and accumulate enough funds for retirement.*
- *You must remember that selection of a pension fund manager/advisor and choice of investment plan will play an important role in accumulating necessary resources for your retirement.*
- *It is always advisable to meet your pension fund manager/ advisor and fully inform him about your investment objective, how much risk you can afford to take, and your time horizon. This will enable him to guide you with your selection of allocation scheme.*

To protect investors through diversification in the investment of retirement contributions, SECP has mandated an investment and asset allocation policy under the Voluntary Pension System Rules, 2005. The Policy covers both, the Conventional and Shariah compliant funds and provides detailed guidelines in (SECP Circular No. 12 of 2021).

Individuals can allocate their contributions between equities, debt, money market instruments and commodities in accordance with their investment horizon and risk appetite as reflected in their chosen allocation scheme. To ensure diversification, minimum investment allocation limits for applicable sub-funds have been defined for each allocation Scheme.

A pension fund must offer at least four pension allocation schemes. These are: high volatility, medium volatility, low volatility and lower volatility respectively. Volatility refers to the change in the principal amount invested due to change in price of securities in the portfolio of the sub fund. The high volatility allocation scheme is equity intensive, and for the rest the equity component gradually diminishes, and finally disappears, substituted by debt and money market schemes. A participant can choose the percentage of contribution that goes into each fund subject to the minimum allocation limits prescribed for the applicable allocation scheme. The allocation of pension assets can be changed by the participant.

Pension funds offering three/four sub-funds

Allocation schemes and minimum allocation requirements prescribed by SECP for a pension fund offering three/four sub funds i.e. equity/index, debt and money market are presented below.

Allocation schemes	**Risk/return profile**	**Equity/Index sub- fund (minimum allocation)**	**Debt sub- fund (minimum allocation)**	**Money Market sub- fund (minimum allocation)**
High volatility	High	65%	20%	(Nil)

Medium volatility	Moderate	35%	40%	10%
Low volatility	Low	10%	60%	15%
Lower volatility	Lower	(Nil)	40%	40%

Pension funds offering four/five sub-funds

Some pension funds in addition to the equity/index, debt and money market may also offer a commodity sub- fund that specializes in commodities. Allocation schemes and minimum allocation requirements prescribed by SECP are presented below:

Allocation schemes	Risk/return profile	Equity/Index sub -fund (minimum allocation)	Debt sub- fund (minimum allocation)	Money Market sub-fund (minimum allocation)	Commodity Market sub-fund (minimum allocation)
High volatility	High	40%	20%	(Nil)	Max 25%
Medium volatility	Moderate	20%	40%	10%	Max 15%
Low volatility	Low	5%	60%	15%	Max 5%
Lower volatility	Lower	(Nil)	40%	40%	Nil

If a pension fund wants to provide additional allocation schemes or products, (for example Lifecycle products) it may do so subject to the approval of SECP.

Under the VPS schemes the individual has the choice of changing the allocation of funds during his/her working life. Younger individuals can take on more risk early in their career by focusing on capital appreciation through investing primarily in equity securities, and take a conservative position later as they get closer to retirement.

It may be noted that in the event that no choice is made by the participant, a pension fund manager (PFM) keeping in view the profile and age of the participant will allocate the contributions to an approved lifecycle scheme, if such a scheme is offered by the fund. However, if a life cycle scheme is not offered by the fund then the PFM will allocate contributions to either low volatility or a lower volatility scheme.

11. Benefit disbursement stage

Important: *As you get closer to the distribution stage your investment should be concentrated in money market and debt sub- funds. It is always advisable to consult with your pension fund manager/advisor to help you plan the withdrawal of your pension fund balance*.

The following should be noted about the Benefit disbursement stage:

- On retirement, you can withdraw up to 50 per cent of the amount in your individual pension accounts tax free. The remaining (or entire balance) can be invested in an income payment plan.
- You can also enter into an agreement with a pension fund manager to withdraw from the remaining (or entire balance) in your accounts in monthly instalments as per an income payment plan approved by SECP.
- On the death of a Participant, the total amount of the individual pension account of the deceased participant shall be divided among the nominated survivors according to the succession certificate issued in accordance with the law for the time being in force.
- Participants who want to withdraw their money before retirement from their individual pension accounts would be subject to the conditions laid down in the Income Tax Ordinance, 2001.

12. Fees and charges

The following fees and charges are applicable to investors in a pension fund:

Front-end fee / Sale load

A front-end fee / sale load of maximum up to 3% is charged on the amount of contribution to the individual pension account. Front-end fee is not payable in respect of a balance a participant has transferred from a previous pension fund manager, or on the employer pension funds, or on the balance a participant has transferred from a recognized provident fund.

Management fee

Management fee in respect of each sub-fund is charged by a pension fund manager as per their offering document for managing the balance in a participant's individual pension account. .

Trustee fee

This is the trustee's remuneration for services and consists of reimbursement of actual custodial expenses as well as annual charges.

Other Expenses

Other Expenses like auditor fee, shariah advisory fee, legal fee, bank fee and other expenses which are necessary for the conducting operations the pension fund may be charged by a pension fund manager.

13. Net asset value per unit of a sub-fund (NAV)

The net asset value per unit of a sub-fund (NAV) represents the value at which the units of the respective sub-funds can be issued or redeemed each working day. It is calculated for each sub-fund by dividing the net assets of that sub-fund by the number of units outstanding in respect of that sub-fund. This value represents the share of each unit of sub-fund in the net assets of the pension fund.

NAV = net assets of the sub-fund/number of units outstanding for the sub-fund

14. Risks associated with investment in VPS

Pension schemes are subject to the following investment risks.

Credit risk

Credit risk is defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms, such as payment of interest or repayment of capital or any other financial or legal obligation.

Market risk

Overall "market risk" is the greatest potential danger for investors in equity/stocks funds. Stock prices can fluctuate for a broad range of reasons such as the overall strength of the economy or demand for particular products or services. The value and income generated by the securities held by pension funds may decline in response to specific events. These may include:

- Industry downturn in companies whose securities are owned by the funds.
- Local or global economic instability.
- Currency and interest rate fluctuations.

Interest rate risk

This risk means that an investment's value will change due to a change in the absolute level of interest rates. Normally, rise in interest rates during the investment period may result in reduced prices of the held securities. Funds that invest in longer-term bonds tend to have higher interest rate risk.

Liquidity risk

This arises from lack of marketability of an investment that cannot be quickly sold to convert to cash without incurring a loss. Thinly traded securities carry the danger of not being easily saleable at or near their real values. Liquidity risk is a characteristic of the fixed income market

15. Tax Credit on contributions

Contributions made in voluntary pension scheme during any one tax year (July 1 to June 30) are entitled to a tax credit under Section 63 of the Income Tax Ordinance 2001. The tax liability can be reduced for both self-employed and salaried individuals. You can avail tax credit at your average rate of tax on the amount of actual contribution or 20% of your annual taxable income whichever is lower.Please refer to the Section 63 of the Income Tax Ordinance, 2001..

Pension funds frequently asked questions (FAQs)

1. How frequently is one required to contribute to the individual pension account?

There is no set frequency for contributing to an individual pension account. It is the participant's own decision. However, for better planning, it is strongly recommended that a participant contributes to his individual pension account in a systematic way.

2. What happens to the contributions made to the individual pension account?

Once contributions are made to an individual pension account, this amount, after charging front end fee/ sales load, is credited to the individual pension account. The net amount is then used to purchase units of different sub-funds of the pension fund as per the allocation scheme selected by the participant. These sub-funds invest in equity/index, debt, money market and commodity instruments and earn returns in the form of dividend, interest and capital gains. Different types of returns earned by the net assets of the pension fund are explained below:

•Dividend income: It is earned on the equity securities in which the equity sub-fund makes investment.

•Interest: This is income earned on the debt and money market securities held by the pension fund.

•Capital gains: These are the gains/ returns resulting from purchase/sale of securities.

3. What is an account statement and what are the charges associated with it?

An account statement is a report of an individual pension account. The statement is sent to the participant by the pension fund manager, free of charge, within 30 days of the close of June 30 and December 31 each year. The account statement provides information about the amounts received or withdrawn, and tax deducted; the number of units allocated and held; and the current valuation of the units, etc.

4. Does the SECP guarantee the benefits under VPS?

No. SECP as regulator of the VPS only monitors and regulates the activities of the pension fund, the pension fund manager, and the trustee of the pension fund. The VPS is a defined contribution pension plan which means that it is prone to market risks faced by similar investments in the capital, debt, money market, and commodity markets. The benefits under the VPS are dependent on the contributions made by or on behalf of the participants and investment performance of their portfolio.

5. What is the cost of transferring the balance in an individual pension account from one pension fund manager to another pension fund manager?

There is no cost. A participant is allowed to transfer the balance in the individual pension account from one pension fund manager to another pension fund manager free of cost.

6. Can a participant change pension fund manager?

Yes, a participant can change pension fund manager. It shall be at the discretion of participant to transfer the entire balance or make a partial transfer. There shall be no fees/charges payable to the existing/new pension fund manager in the event of such a transfer.

7. How can one assess the performance of the pension fund?

One can assess the performance of a pension fund by evaluating:

- Performance against returns generated by other pension funds.
- Performance of the pension fund in comparison to the overall capital market of the country.
- Growth in the balance of the individual pension account over a period.

8. What does retirement mean under the VPS?

Under the VPS, retirement means discontinuation of the contributions and starting to receive payments out of a participant's final accumulated balance on reaching the retirement age. Retirement age can be between 60-70 years, and is selected by the participant or after 25 years of contribution.

9. What happens to an individual pension account in the event of death before retirement?

In the event of death of a participant before attaining the retirement age, the units in the individual pension account will be redeemed at the net asset value as of the dealing day of notice of death, and credited to his/her individual pension account and will earn the applicable rate of interest on such deposits. The total amount will then be divided between the nominated survivors as per the succession certificate issued in accordance with law for the time being in force.

Each of the nominated survivors will have a number of options:

- Redeem the balance allocated subject to the provisions of Income Tax Ordinance 2001; or
- Transfer the balance to an individual pension account to be opened with the same or a new pension fund manager; or
- Purchase an annuity from an insurance company or a pension fund manager, if nominee's age is 55 years or more; or
- Purchase a deferred annuity from an insurance company or pension fund manager to commence at the age of 55 years or later.

10. What happens if a participant dies during the period in which they are receiving payments under an approved income payment plan?

If a participant was receiving payments from an approved income payment plan and death happens, the units in the individual pension account will be redeemed at the net asset value of the dealing day of notice of death. Proceeds will be credited to individual pension account and will earn the applicable rate of interest on such deposits. The total amount will then be divided among the nominated survivors.

11. What if a participant suffers from disability before the age of retirement and is unable to make further contributions?

If, before attaining the planned retirement age i.e., between 60 to 70 years, a participant suffers from a disability rendering him/her unable to continue employment and make further contributions, it will be mandatory for the participant to produce a doctor’s assessment certificate, confirming the disability. On retirement due to disability, the participant will have the same options as are available on reaching retirement age. The VPS rules list the types of disabilities against which a participant can claim to have reached the retirement age.

12. Why should a participant opt for an approved annuity plan?

An approved annuity plan is a plan approved by SECP and offered by life insurance companies or pension fund managers approved by the SECP. An annuity by its very nature can be called a financial plan that makes a regular stream of payments to the annuity holder. A participant is required to deposit a lump-sum amount with the life insurance company to purchase an approved annuity plan. Upon receipt of the amount, the life insurance company or pension fund manager will start paying regular income to the participant in accordance with the plan selected.

13. Why should a participant opt for an approved income payment plan?

If a participant can afford to assume risk in expectation of returns that are above moderate, he should buy an approved income payment plan. The expectation of above moderate returns implies it can work both ways i.e. a participant can experience lower payments of income as well as returns that can be above moderate.

14. Is it mandatory to buy an approved income payment plan from the same pension fund manager or can a participant choose another pension fund manager?

No, it is not mandatory to buy the approved income payment plan from the same pension fund manager with whom a participant is maintaining his/her individual pension account at the time of retirement. On attaining retirement age, the participant may go to any of the registered pension fund managers and buy an approved income payment plan.

15. Can the balance be transferred from a recognized provident fund, to an individual pension account, opened under VPS?

Yes, one can make a full or partial transfer of the balance from a recognized provident fund to an individual pension account. There are no restrictions on such transfers under the VPS Rules or the Income Tax Ordinance, 2001. However, tax credit is not allowed on transfer of balance from a recognized provident fund to an individual pension account.

16. Is it mandatory for a participant to withdraw 50% out of the accumulated balance in the individual pension account? What if he does not want to withdraw this amount?

No, it is not mandatory to withdraw 50% out of the accumulated balance at the time of retirement. Instead of opting for the permissible tax-free withdrawal of an amount up to 50% of the accumulated balance in the individual pension account, a participant can use this amount for purchasing an approved income payment plan/approved annuity plan.

17. Does a participant receive all the tax incentives in case of disability before the retirement age?

Yes, a participant will receive all the tax incentives available on retirement age because of early retirement due to disability.

18. Is there any tax on transferring the balance from one pension fund manager to another pension fund manager?

No. The transfers can be made, from one pension fund manager to another pension fund manager, absolutely tax-free.

19. What if a participant has a complaint against the pension fund manager or distributor?

If any complaint or dispute arises between a participant and the pension fund manager, the participant should approach the pension fund management. If the situation is not resolved, for filing your complaint online, use the Service Desk tab on the SECP website (www.secp.gov.pk); or send an email to: complaints@secp.gov.pk