

Shariah Perspectives on Pension Provision

International Takaful Summit 2010

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Presented by:

Faizal Manjoo

Outline

- 1. Definition of pension.
- 2. The ageing population phenomenon and its impact on the pension industry.
- 3. Some Statistics for Muslim population that may highlights the need to look into the pension issue.
- 4. Fiqhi Problems in establishing an Islamic Private Pension fund
- 5. A proposed model?
- 6. Need for Longevity Sukuk

Definition

- A pension system is designed to protect an individual against the **financial risks of an uncertain life expectancy**. Accordingly pensions and annuities provide periodic money payments to a person who retires from employment because of age, disability, or the completion of an agreed span of service.
- The payments generally continue for the remainder of the natural life of the recipient, and sometimes thereafter to a widow or other survivor.
- In practice a pension is provided from the purchase of an annuity from an insurance company.

Pension models in Islamic world

- Umar bin Khattab (RA)
- Uthman bin Affan (RA) & Abu Ubaydah (RA)
- Baitul Mal & Islamic Social system waqf and family responsibility
- Ottoman – soldiers job made lighter
- Modern day set up nothing exists really!!!

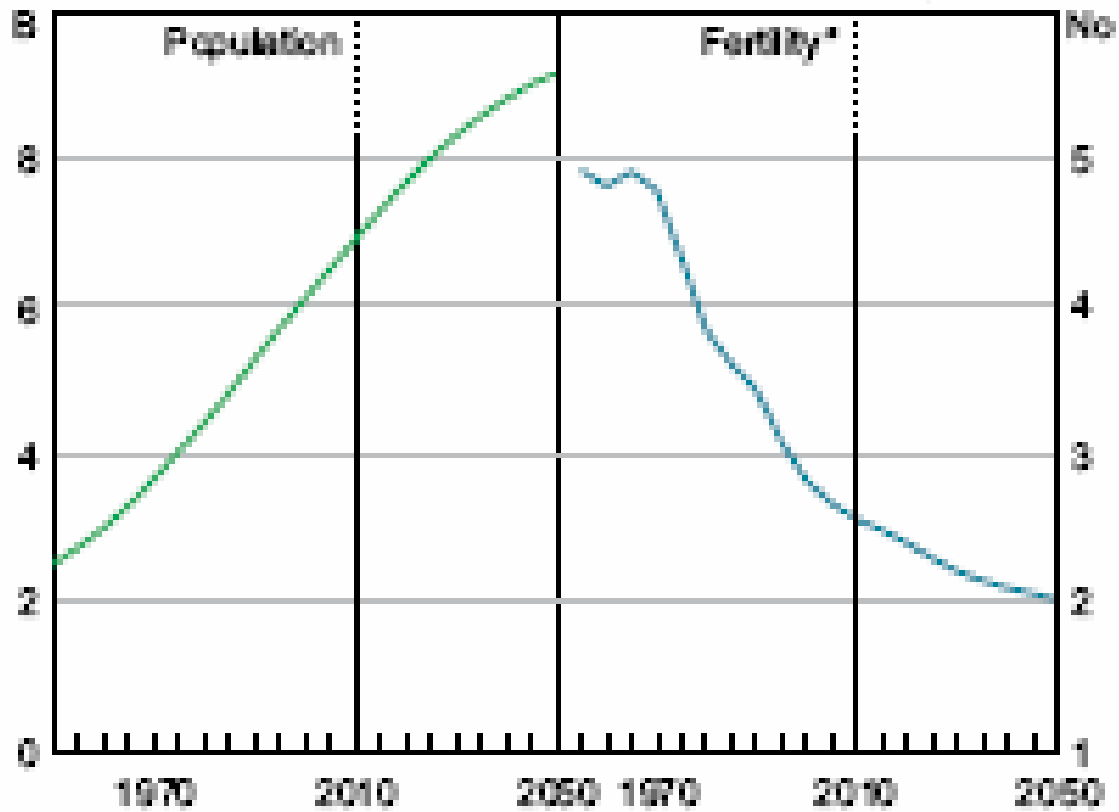
Evolutionary Implications

- Legal nexus was paternalistic
- Then it became state pension – relation with state – **non-funded pension but an acquired right**
- Private sector pension - optional/compulsory/incentive **funded pension. Not necessarily an acquired and guaranteed right!**
- Now due to ageing population people are asked to cater for themselves as the state pension is not adequate and also retirement age is being increased. **They bear their own risk!! (DC)**
- PADA is semi-governmental. Employer contributes 3 %, employee 4% and tax rebate 1%. This is transferable.
- New theory of savings!!!

Changes in Pension Landscape

- Ageing population: life expectancy increased drastically.
- Fertility rate dropped: more women working and accessing education – having less children thus more ratio of death rate is less than birth rate.
- Dependency ratio will drop to 0.5 by 2050 in OECD countries.

World – Population and Fertility



* Children born per woman
Source: United Nations

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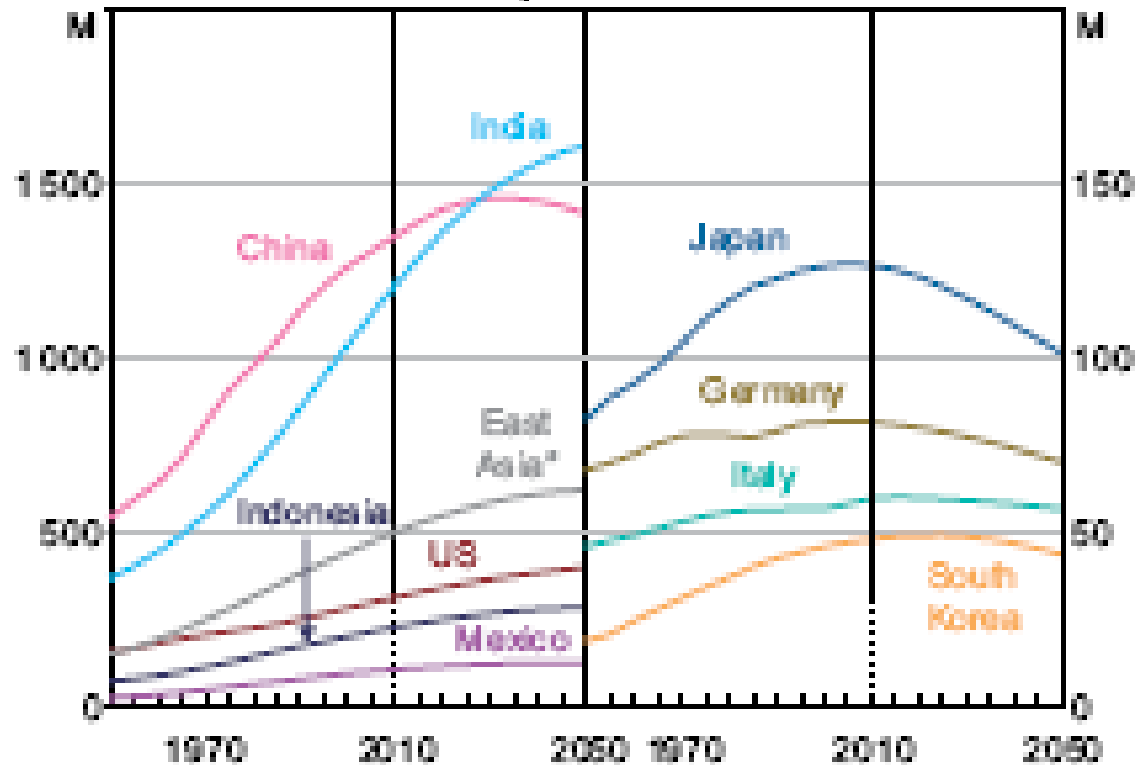
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Population



* Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand

Sources: United Nations; US Census Bureau

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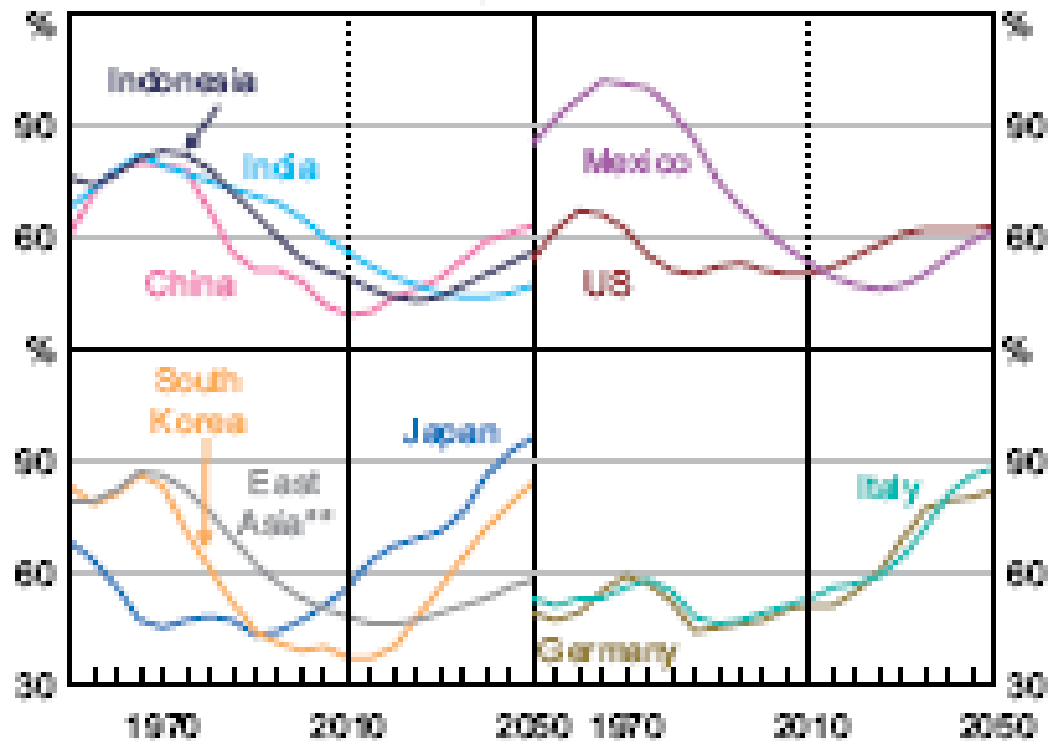
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Dependency Ratios – Total*



* Non-working-age population as a percentage of the working-age population

** Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand

Sources: United Nations; US Census Bureau

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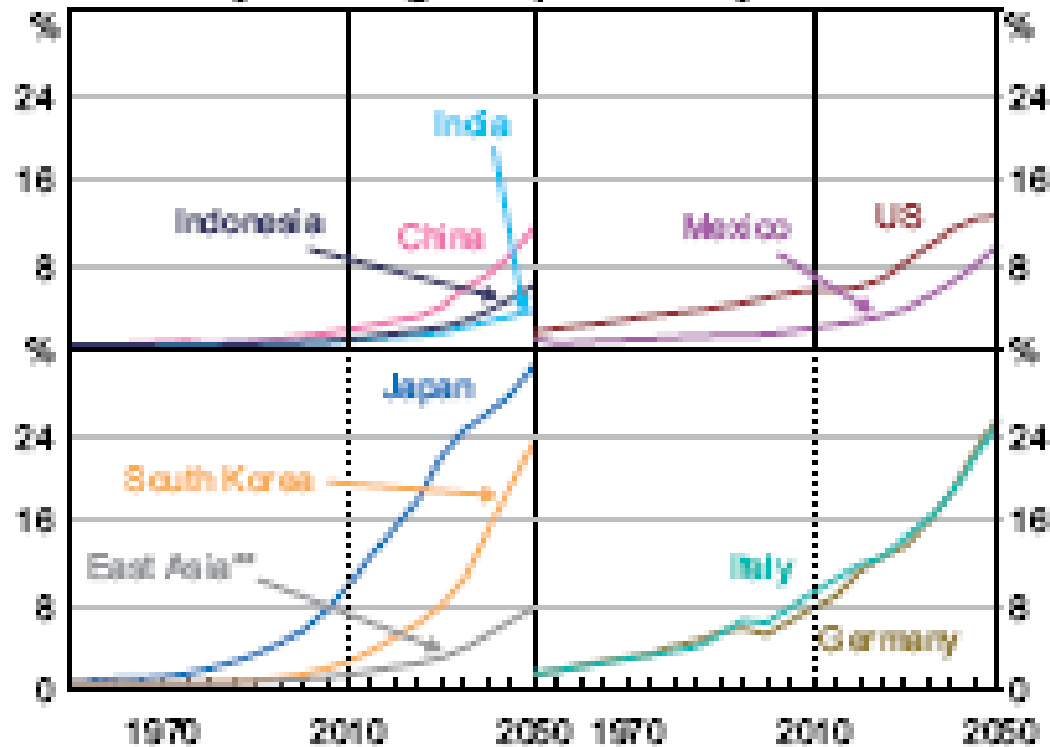
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Very Old Age Dependency Ratio*



* Population aged 80 or more as a percentage of the working-age population

** Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand

Sources: IBA; United Nations; US Census Bureau

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Implications for Ageing Population

- Intergenerational issues – lack continuity of dependency ratio
- Cross-border challenges – economic dependence of G8 market
- Migration policies – affect local markets

Implications for Ageing Population

- Major shift in medical field & health care – more elderly people higher pressure on government budget, more demand for Doctors and medication. Transport, Entertainment & Tourist industry – major shift in destination and modes of Transport and music industry. >3% point of GDP increase till 2050
- Amenities – Old people stay at home may affect gas and electricity consumption.
- Security system – more cash needed to sustain old people. 3-4 percentage points of GDP over the period till 2050.

Scope for Financial Institutions

- Total age-related expenditure relative to GDP could rise on average by about 7 percentage point till 2050!!!
- Creation of new pension schemes
- Creation of new health insurance, transport insurance product,
- Financing of new amenity facilities
- Financing of financial products to meet needs of old people.
- Islamic Financial institutions will also have the opportunity to [plan for these as the Muslim world is following the same trend as in the OECD countries.

Basic Statistics for Middle East

- 1950 – 2000 explosive population growth 92m to 349m.
- Now there is a demographic transition. 1.3% population growth rate for 2000-2050 which half of the period 1950-2000.
- Dependency ratio was 1 in 1960-1980, 2000:0.75 and in 2030:0.58
- But as elderly people increase dependency ratio will reach 0.66 in 2050

Percentage of the youth cohort *aged 24 years and below* drops over the next three decades

State	2000	2020	2030
Egypt	55.7	32.5	28.1
Turkey	50.4	39.2	35.7
Iran	59.3	42.4	38.9
Pakistan	61.0	56.2	51.4
S. Arabia	62.3	56.1	52.1
Iraq	61.7	53.9	47.2
Yemen	65.3	68.4	65.7
Algeria	56.5	40.9	37.4
Indonesia	50.7	39.5	36.4
Morocco	55.1	43.4	38.4

Source: UN World Population Statistics

Retirement

- Working age ratio has been 9e since 1950 reaching 9.6 in 2000.
- It is expected to reach 3.2 in 2050.
- The demographic dividend is when the middle-aged save for their retirement, because those savings could fund investment that raises national income. Policies for savings need to be enhanced.
- A major shift in Middle East is the role of women in the labour market is on the increase!! Need to cater for them as well.

Need to shift towards Private Pension

- The situation in the Middle East and also in most Muslim countries is that there is budgetary constraints for contributing towards old age state pension.
- It is becoming less reliable and also volatility of investment market is becoming more unpredictable with regular bubbles.
- The UN advise for the 3 pillars for maintenance in old age: State pension, private pension and other sources .

Need for an Islamic Pension Fund

As per definition of pension, conventional will ultimately embrace *riba* and *gharar* because one will most probably buy an annuity from an insurance company to sustain himself after retirement.

Some Fiqhi issues within Conventional pension

- **1.** whether the purchase of an annuity for retirement is permissible in Islam as it involves *riba* (interest) and *gharar* (excessive uncertainty)?

Some Fiqhi issues within Conventional pension (cont)

- **2.** whether marriage is an economic venture whereby partners can claim from the other partner's estate upon divorce in Islam?

Some Fiqhi issues within Conventional pension (cont)

- **3.** whether inheritance law is an issue on testate succession, since the issue of beneficial interest in pension receipts is not directly acceptable?

Some Fiqhi issues within Conventional pension (cont.)

- **4.** whether the accumulation of supporting funds, such as Zakah, as investments in itself poses a challenge to Islamic law for the reasons mentioned above?

Some Fiqhi issues within Conventional pension (cont)

- **5.** whether alternative forms of decumulation (other than annuities) are also unacceptable in their current form?

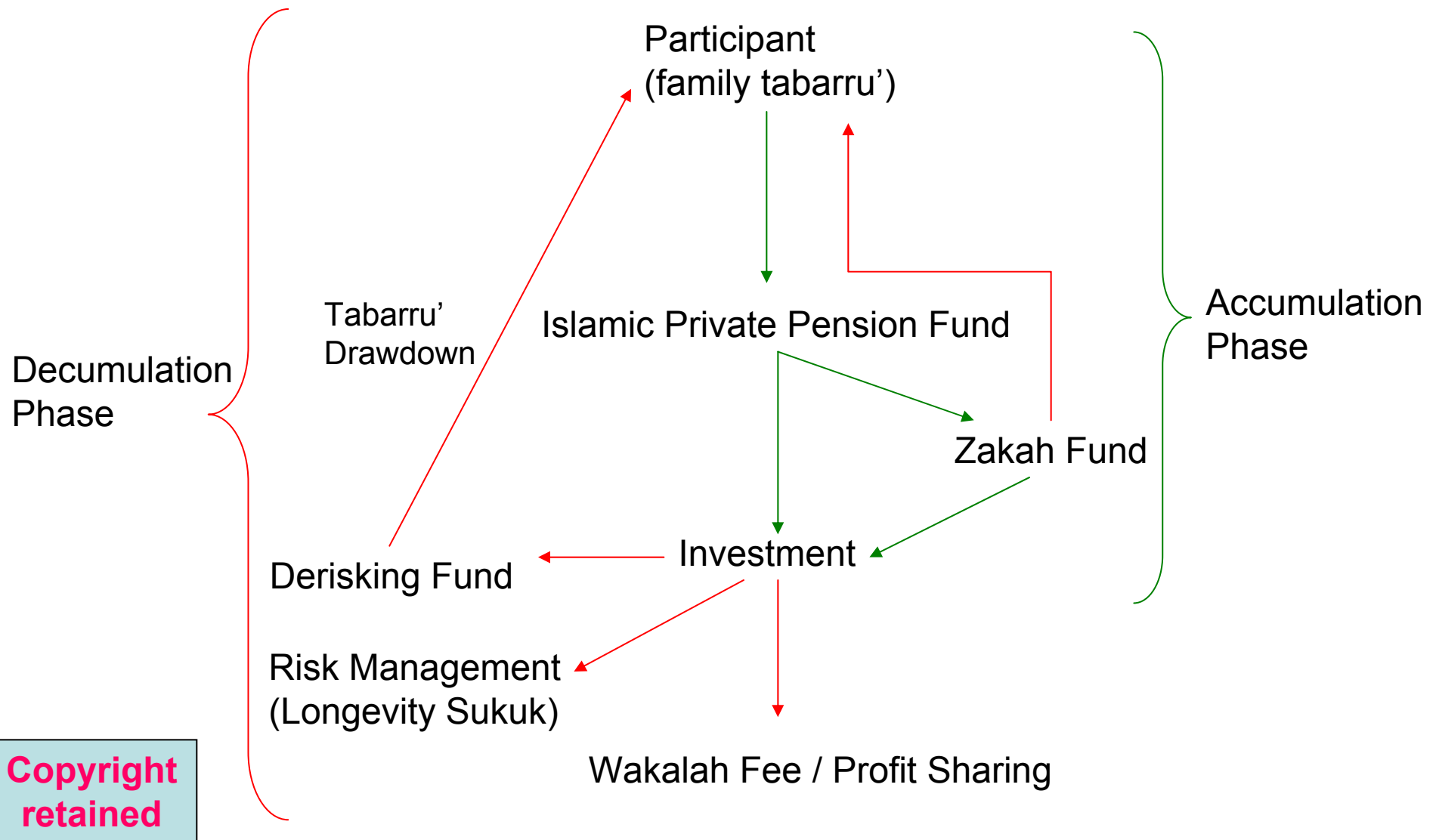
Some Fiqhi issues within Conventional pension (cont)

- **6.** whether appropriate and sufficient shari'ah-compliant investments are available?

Some Fiqhi issues within Conventional pension (cont)

- **7.** whether a shari'ah-compliant approach to conventional actuarial assumptions is possible?;

Suggested Model for Private Islamic Pension Fund

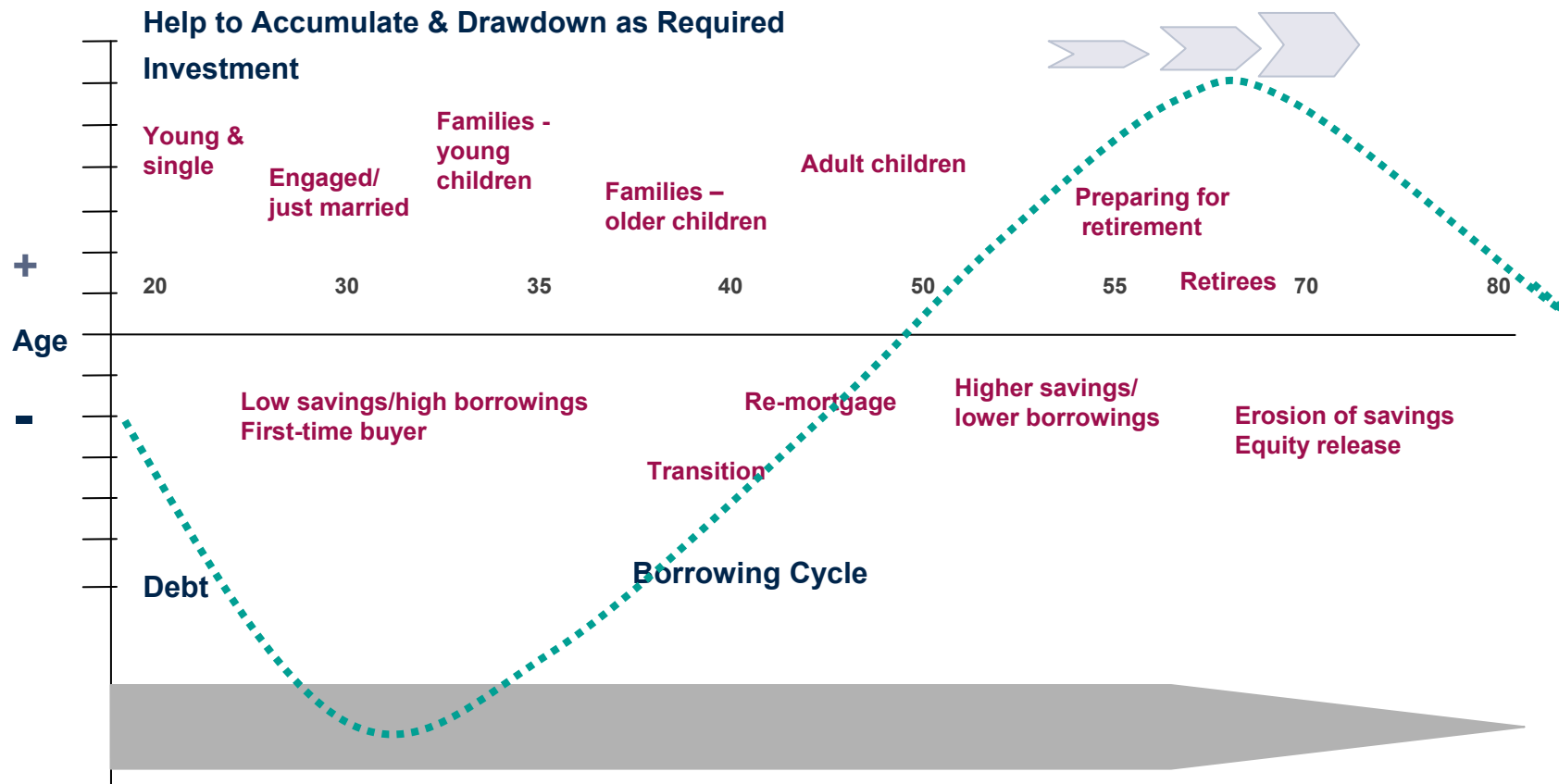


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Employee Life Cycle



Debt, Savings, ISAs, Mortgages, Share Plans, Pensions, GSIPP, Drawdown, Annuities



Longevity Risk

- *The risk that a policyholder lives longer than anticipated.*
- *Longevity risk is associated with (re)insurance obligations (such as annuities) where a (re)insurance undertaking guarantees to make recurring series of payments until the death of the policyholder and where a decrease in mortality rates leads to an increase in the technical provisions, or with (re)insurance obligations (such as pure endowments) where a (re)insurance undertaking guarantees to make a single payment in the event of the survival of the policyholder for the duration of the policy term.*

Decomposition of longevity risk

Total longevity risk

=

Aggregate longevity risk
(Trend risk)

+

Specific longevity risk
(Random variation risk)

Government
needs to
provide hedge

Private sector
can hedge

Source: Pensions Institute

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Impact on (Re)Takaful Companies

- Solvency II, if adopted, will require insurers to hold significant additional capital to back their annuity liabilities if longevity risk cannot be hedged effectively or marked to market.
- Global pension private-sector liabilities are of the order of \$25trn. UK government-backed longevity-linked liabilities exceed £2trn.
- With increase life expectancy there will be 1 unhealthy concentration of risk, 2. under solvency II insurance liabilities are to increase by the addition of a market value margin (MVM) reflecting the cost of capital to cover “non-hedgeable” (6% cost of capital above risk-free rate when calculating (MVM)).

YOUR HOMEWORK!!

- FORMULATE THE ALCHEMY FOR THE LONGEVITY SUKUK BOTH FOR AGGREGATE AND SPECIFIC LONGEVITY RISK

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