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Early Bird Seminar on
Current issues for Retirement Benefit
Schemes and Funds

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Ladies and Gentlemen, Assalamu aleykum, I wish you all peace.

Welcome to this Early Bird Seminar on Current Issues for Retirement Benefit Schemes and Funds. A special welcome for those who have travelled long distances to be with us today.

Retirement sets in motion a complex, multi-dimensional train of events. Let us explore these, so that we understand the problem that we are trying to solve.

The US Society of Actuaries arranges for surveys on the risks and phases of retirement. The latest survey is on their website www.soa.org. Much of the material is specific to the USA. But many points are universally applicable. What now follows takes many points from that survey, but modified and adapted to Pakistan.

I submit that the phases of retirement have at least three dimensions. Dimension A describes the phases through which the retiree himself or herself may pass.

Table 1 Phases of Retirement Dimension A: Retiree himself/herself

Phase	Description
A.1	# Capacity essentially the same as before retirement. # May do paid or volunteer work
A.2	# Diminished physical/mental capacity # Likely to slow down or discontinue work. # Health care costs likely to rise
A.3	# Totally unable to work # Cannot sign cheques, or other documents # Hardship in drawing pension and other benefits which require visits to prove survival # May need help in day to day living # Health and other care costs likely to rise substantially.

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Remarks on Dimension A of Retirement Phases

- # Phases are not sharply demarcated. Usually, a Phase would change gradually into the next Phase.
- # Every retiree may not pass through all Phases.
- # Retirement can end in Phase A.1 or Phase A.2 by accidental death, or a short but fatal illness, like a massive heart attack.
- # Ill Health Retirees are likely to skip Phase A.1 and go straight to Phase A.2.
- # The length of any Phase will vary from individual to individual. Some may live to a great age in Phase A.2, with a short Phase A.3, or no Phase A.3.
- # Retirement ends with the death of the retiree and his spouse. This period will vary from case to case. In the worst case, both may die in an accident soon after retirement. Or both can live into their nineties, in which case Retirement may last for perhaps 50 years.

Where the retiree and spouse are both alive at retirement, this creates two more Dimensions, B and C. Let us first look at Dimension B, which relates to the survivor status of this couple.

Table 2 Phases of Retirement Dimension B: Survivor status of retiree and spouse

Phase	Description
B.1	Both alive. Dimension C will also apply.
B.2	Retiree dies, leaving spouse. Dimension C will apply.
B.3	Spouse dies, leaving retiree

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Remarks on Dimension B of Retirement Phases

- # Actuarial studies show that when a spouse dies, the expectation of life of the remaining spouse reduces. The reasons are complex.
- # In Pakistani management, husbands are 6 to 8 years older than wives, and female mortality is lighter than male mortality. So B.2 is much more common than B.3.
- # If there is a pension scheme (for example in Federal and Provincial Governments, the Defence Services, and a limited number of organisations in industry and commerce) it is usual for a reduced pension to continue to the surviving spouse after the retiree's death. So the lengths of Phases B.1, B.2 and B.3 affect scheme finances.

The reduction in household income on the retiree's death may, or may not, be matched by a reduction in expenses.

Where the retiree and spouse are both alive at retirement, then the family budget also has to provide for the spouse's health and old age care costs as long as she/he is alive, i.e. as long as Phases B.1 or B.2 exist. This gives rise to Dimension C, which relates to the health status of the spouse.

Table 3 Phases of Retirement Dimension C: Health status of spouse

Phase	Description
C.1	Spouse in reasonably good physical and mental health.
C.2	Spouse's physical/mental capacity diminishes. Health care costs likely to rise
C.3	Spouse needs help in day to day living. Health and other care costs likely to rise substantially.

Health and other Care Needs and Costs

Medical problems increase with age. This is common sense. There are no Pakistani statistics on this increase. Some US statistics are given below, down-loaded from a US Govt publication "Health, United States, 2008". They will not apply 100% to Pakistan. But at least they give a general idea.

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Table 4 : Selected US age-wise figures on health

Item	Ages under 65	Ages 65-74	Ages 75-84	Ages 85 and over
Hospital In-patient discharges pa (2005-2006)		26 %	41 %	57 %
Visits to doctors, O/P, & emergency (2006)	3.40 visits per head	6.65 visits per head	8.24 visits per head	
Activity limited by Cardio Vascular conditions		9 %	14 %	21 %
Activity limited by musculo-skeletal conditions, like arthritis		12 %	17 %	27 %
Health care expenses per head, including medicines (2005)	\$ 3,239 per head	\$ 9,074 per head		
Nursing Home residents (2004)		1 %	4 %	14 %

Many old people who need assistance with day to day living are cared for by their families. So the last row of Table 4, showing Nursing Home residents, under-states the problem of such assistance.

So you can see how sharply Health and other care needs and costs increase with age. Please remember that these will increase not only for the retiree but also for his or her spouse.

Conceptual Solutions

The multi-dimensional phases of retirement, and the health and other care needs and costs, require solutions. Conceptually, there are three parts to the solution:

Retirement Income to cover normal living expenses: Retirement income is a generic term. It includes pensions from state schemes, like EOBI. It includes Defined Benefit pensions from employers. It includes income from investing an accumulated fund, like a DC pension fund, or a DC Provident Fund, or a Gratuity. It includes income from voluntary savings by the individual.

Net of taxes, the Retirement income should cover normal living expenses. It should increase with inflation.

Health care: This can be provided in kind, i.e. actual care delivered. This is the case in the welfare states of Western Europe, and Canada. The US has a system for old people which is not as comprehensive, but which goes a long way.

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Pakistan has no such system. So, until such a system is set up, in theory there should be a Cash Flow, net of taxes, to pay for Health Care. To match the need, the Cash Flow should increase sharply with age. It should be able to cope with health catastrophes, like severe Parkinson's disease, or severe Cardio-vascular problems, kidney failure or cancer. The pattern for any one retiree and his or her spouse is unpredictable. And this Cash Flow should increase with inflation in medical costs.

It is extremely difficult to provide such a matching Cash Flow. But the problem won't go away, so some solution has to be attempted, however, deficient it may be.

Assisted living: Welfare states provide this by Nursing Homes, Old People's homes. There is no such system in Pakistan, although some charities do try to help. Only the family can provide the care for assisted living. Family members do not charge for their time. But there are invariably additional costs which require Cash Flow. Like Cash Flow to meet health care, this is an unpredictable item.

Role of Government

Government's role in Retirement Income

According to the Labour Survey 2005-06, the Pakistani work-force numbered 50.05 million, including 39.97 million males and 10.08 million females.

In developed countries like the USA, Canada and European countries, state schemes like US Social Security provide the biggest part of income for the great majority of retired persons. In the same way, for the overwhelming majority of Pakistan's labour force, the only hope of retirement income is to extend the state's EOBI scheme. In January 1993, I read a paper to a tripartite conference, and proposed the phased extension of EOBI over 20 years, to the whole of the labour force. This proposal was warmly welcomed, especially by the employers' representative. In fact, he said "let's not wait for 20 years, let's do it immediately". Well, the 20 years will run out in 2013. After 15 years, the first small step was taken in 2008, by extending EOBI to organisations with at least 5 employees, instead of the previous threshold of 10, and removing the exemptions of banks.

Committees and Commissions set up by various political and caretaker Governments recommended the phased expansion of EOBI. Let us hope that one day these reports will be located, dusted off and implemented.

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Government's role in Health Care

Provincial Social Security Institutions were created under the Social Security Ordinance, 1965. They provide medical and surgical care to covered workers, and to some extent to their families.

Unfortunately, like EOBI, their scope has not been significantly expanded after the initial legislation. Cover ceases on retirement.

The Provincial Governments should, with the help of the Federal Government, expand the Provincial Social Security Institutions to deliver health care to the entire population, including retired persons.

We don't have to go far to see how retirement income and health care is provided to the entire population. Iran has done this fairly well, because there was a political decision at the highest level to do this. We don't have to follow the Iranian model in every full stop or comma. But it shows that where there is a will, there is a way.

Unfortunately, neither the Federal nor the Provincial Governments seem to be interested in expanding EOBI or in expanding the scope of the Provincial Social Security Institutions. So the future for the great majority of working Pakistanis seems bleak after retirement.

Government's role in Assisted living

We can forget about this. It can be considered only after the basic two items, Retirement Income and Health Care have been tackled.

Employers' Role

Standing Order 12(6) requires every industrial establishment with at least 50 employees, and every commercial establishment with at least 20 workmen, to pay a gratuity to a workman on cessation of service, for any cause other than misconduct. The gratuity is 30 days' last drawn wages for each year of service. The Supreme Court, in the *Zain Packaging* case, decided that the gratuity should be on gross salary, including all regular monthly payments.

This is a compulsory Defined Benefits (DB) scheme. The gratuity does not have to be funded, and can be covered by a balance sheet reserve. If the gratuity is not funded, then cash outflow in respect of any workman is deferred till cessation of service.

If the Employer has a Provident Fund, to which he contributes at least as much as the Employee, then the gratuity is not payable for any period covered by the Provident Fund. So the Employer can opt to

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replace the unfunded DB gratuity by a funded Defined Contribution (DC) Provident Fund. But this means immediate cash outflow by way of contributions to the Provident Fund.

It is significant that in the industrial and commercial sector, the vast majority of retirement benefits are provided under statutory schemes, namely EOBI and Standing Order 12(6). Voluntary retirement benefits provided by Employers cover relatively few employees. This proves that in Pakistan, as in most other countries, the law must lead.

Outside the purview of EOBI and Standing Order 12(6), an Employer who wishes to provide retirement benefits can choose from (a) Provident Funds (b) Pension Funds (c) Gratuity schemes or Funds.

Provident Funds are by definition DC. Most Employers regard these as the first step in providing retirement benefits.

Some people, including itinerant consultants appointed by International Agencies and other visitors from abroad, do not regard Provident Funds (and the 12(6) Gratuity) as retirement benefits, because the employee who leaves before retirement age, perhaps at a young age, can take the benefit and spend it.

But every year, there are thousands of cases where at the point of retirement, the Provident Fund was the only benefit, or the main benefit.

Another opinion tossed about is that Provident Funds are eaten away by withdrawals for marriage, religious festivals and other such temporary purposes. However, such withdrawals have to be repaid over 48 months, at the most, and carry interest. We at Akhtar & Hasan have substantial experience of administering Provident Funds, which have been outsourced to us. On the average, at any given time only 5% to 6% of the Fund is outstanding as repayable withdrawals.

One must not be dismissive about Provident Funds, and nothing should be done to damage them.

The Finance Act, 2008, took a swipe at Provident Funds. A limit of Rs 100,000 per annum was placed on Employer contributions to a Provident Fund in respect of any employee. The excess is now taxed in the hands of the Employee. No reason for this measure was given. And surprisingly, nobody objected, probably because the amendment was buried in the fine print.

I feel that the amendment should be reversed in the Finance Act, 2009.

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Pension Schemes are much fewer than Provident Funds. Until a decade ago, they were DB. But in the last decade, hardly any new DB Pension Schemes have been set up, and several existing DB Pension Schemes have been converted to DC.

Gratuity Schemes are much more numerous than Pension schemes. They are almost all DB schemes, but one or two have converted to DC.

A big current issue: DB vs DC

Under a DB scheme, the employer faces 5 risks:

- (1) The future salary risk.

<p>It is possible to have DB schemes which avoid the future salary risk. This can be done by basing pension or gratuity on career average salary. Or by defining the benefit as so many rupees for each year of service.</p>
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- (2) The investment yield risk.
- (3) The asset value risk.
- (4) The longevity risk. But the longevity risk does not arise under a DB gratuity scheme.
- (5) The measurement risk: Actuarial costs are calculated under some prescribed accounting standard, like IAS 19 in Pakistan. DB accounting costs are volatile, because of fluctuations in discount rates, sharp swings in market values of assets, and unexpected increases in pensioner longevity. And the standard itself can change. IAS 19 has been amended substantially in respect of the treatment of actuarial gains and losses.

Rating agencies increasingly --- and correctly ---- treated DB liabilities and assets as liabilities and assets of the sponsoring employer.

Every business has its own business risks. So employers began to feel that there was no business case to take the additional risks of DB schemes.

The result is a world wide trend to close down DB schemes entirely, or at least for new entrants. Some DB schemes were closed for new entrants, and for the future service of existing employees. DB schemes had survived for decades, because good and bad years cancelled each other out. There

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was much argument among HR professionals and actuaries that DB schemes were good for employee morale and loyalty. But these soft advantages were cancelled by the hard financial drawbacks of DB.

Provident Funds are DC schemes, which have been around for decades. But now Pension Schemes are switching to DC. Gratuity Schemes are still usually DB, but one or two have switched to DC.

When we switch to DC, the measurement risk disappears. However, the future salary, investment yield, market value and longevity risks remain. **But they are transferred to the employees.**

Generally, employers do not want to retain even a moral responsibility for these transferred risks. They want to wash their hands of them completely.

In developed countries, the employee is asked to choose from a list of optional investment vehicles. HR, Finance and Pensions departments are strictly told not to give any advice to the employee about the pros and cons of these investment vehicles.

On the longevity risk, employers say: buy an annuity from an insurer. On retirement, they leave the employee to choose the insurer. I will say more about annuities later.

And there is no way the employee can transfer the future salary risk. He can only hope and pray that the investment yield, net of market fluctuations, will stay at least level with future salary increases. Or, if he is an optimist, one or two percentages per annum above future salary increases.

Hard-nosed financial considerations have prevailed, and softer HR considerations have gone out of the window.

Almost by definition, the employer is better poised than the employee to understand and manage the future salary risk, the investment yield risk, the market value risk and the longevity risk. The employer either has financial experts on its payroll, or can engage professional consultants. The employee does not have these skills, and cannot or will not usually pay to get them from qualified professionals.

Is this a tenable or durable situation? Some years ago, I was talking to actuaries in our associated firm Mercers in England. There was a consensus that the DC regime would result in many impoverished old people.

So I submit the following personal opinions. I recognise that there is room for alternative views, and I hope I will hear these from today's audience:

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After installing a DC pension scheme, or for that matter a DC Provident Fund scheme, the employer cannot simply say “have a good day”, and walk away from his employees.

There should be a combined set of objectives for any employer’s DC schemes. For example, these objectives could be:

Objectives of DC system

If the size of the scheme permits:

- (a) There should be a target income/cash flow, as a percentage of final salary, to be attained after retiring at say 60 years after say 30 years’ service. The progress of the DC fund should be measured periodically against this moving target, taking into account present salary and projected increases. If necessary, contribution rates should be adjusted to maximise the chances of hitting the target. If the employer is not able to increase his contribution rate, then the employee should be asked to do so. After all, it’s the employee’s old age security we are talking about.
- (b) During service, the fund should on aim to earn an investment yield, net of tax and investment expenses, at least equal to salary increases.
- (c) After retirement, the fund should aim to earn an investment yield, net of tax and investment expenses, at least enough to cover post retirement inflation.
- (d) There should be sensible system of draw down after retirement, not annuitisation.

If we express the objectives in this way, then one thing becomes clear: there is NO safe investment. Investment in fixed return securities, like SSC’s or bank deposits, are totally vulnerable to inflation. In fact they are a gamble on inflation. Investment in long term fixed return market securities, like PIB’s, are in addition vulnerable to market value changes. Bank deposits are subject to a credit risk.

Certainty in this field is a mirage. The only sensible way is to accept that every course has its risks. Long term adequacy and fairness is a moving target.

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Governments in developed countries offer index linked Government securities, where the capital and the periodic yield is adjusted for inflation. They are a hedge against post retirement inflation. They are of course not a hedge against the future salary risk in service. The Pakistan Government does not offer such securities at present. It should consider doing so, after establishing the credibility of the official Consumer Price Index.

The composition of the investment portfolio must maximise the chances of achieving the set objectives.

An employee who serves for 25 or 30 years on a salary knows how to handle his monthly take home. The monthly take home is like a drug injection, to which he becomes addicted. But he does not know how to handle large lump sums.

The chances of the money being mis-invested, or frittered away or squandered are very high. Suppose he resists the blandishments of “Double Shahs” and other Pakistani Madoffs. Suppose he resists the requests of his friends and relations to invest in some “fool proof” business scheme, or doesn’t buy a car for his son or son-in-law. Suppose he “plays safe” and buys SSC’s, or Bahbood or Pensioners' certificates. Then he is in fact gambling on future inflation. The Akhtar & Hasan Letter No 85 of January 2009 points out that at the NEW yield, inflation at 22% is like a 105% income tax on Bahbood and Pensioners’ Certificates.

But employees have a strong preference for lump sums. If the size of the Employer and the size of the Provident Fund permits, perhaps out-going employees should be encouraged to draw down their balance in instalments over a period to be determined by them. The law permits this, if the Trustees agree.

Annuitisation is a mug’s game, at least in Pakistan. From the point of view of a life insurer, selling annuities is risky. The insurer takes an interest rate risk. The Government security market is too thin for the interest rate risk to be hedged. And there is no way the longevity risk can be hedged. As a result, annuities which are prudent for the insurer must contain various safety margins, which will make them un-attractive for the buyer.

And the annuity will be for a fixed annual amount, which will steadily be eaten away by inflation, leading to old age poverty.

The annuity market is non-existent in Pakistan, anyway. It is not wise to make plans based on something that does not exist.

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Draw down is a sensible practice. This has to be managed by the Employer, or by the Trustees who are invariably appointed by the Employer (or in some cases nominated by workmen's representatives). Or managed by some professional asset manager. Actuaries have used their skills to devise draw down schemes. The MSc thesis of my colleague Irfan Ali, submitted to the City University, London, was on this subject. Of course, a small Fund may not find it feasible to permit draw down.

In the draw down system, the periodic withdrawal from the Fund consists of an investment income plus a portion of capital. To work this, the nominal value of the capital should be relatively secure. In the absence of index linked Government securities, this restricts investments to short term fixed return securities. But historically the yields on such securities, net of inflation, have been low, in the range 0% plus or minus 1% or 2%.

Investment in ordinary shares may produce relatively stable dividend income, giving a higher real yield than fixed income securities. But the capital value of a portfolio of ordinary shares can be all over the place, as recent experience shows. A draw down system may be hard to work. Instead, it may be safer only to withdraw the dividend income.

Suppose the employer says: "sorry, I don't want to be bothered by all this. I will make my contributions, and these will be paid out as a lump sum, and the rest is the employee's headache".

If he takes this minimalist view, he still has to consider the following:

If the size of the scheme permits

- Come up with some fair system of allocating the income of the DC fund, and allocating realised and un-realised capital gains and losses.

In the present scenario, many if not all funds have taken knocks on capital values. Suppose a new employee joins. Should he also be saddled with these? Can he not argue that these capital value falls should be exclusively shared among previous members?

If a part of new contributions is invested in shares at present prices, and the values increase sharply in future, can it be argued that these gains should be allocated to those who made these new contributions?

There are various methods of solving this problem in a fair and equitable manner. The present crude system of allocating such gains or losses as a flat percentage can be open to serious question.

In the life insurance business, actuaries have developed the asset share method for equitable sharing of gains and losses among different cohorts of With Profits policyholders.

- Many DC Provident Fund and Pension Schemes need to look again at their Trust Deeds and Rules, to see whether they cater for the present volatility. Do they permit negative yields, i.e a reduction in the accumulated investment income compared with the previous year? Equity between outgoing members, and members who ask for non-repayable withdrawals, and continuing members can raise difficult questions.
- Large funds should consider whether to allow participants to select investment options. Legal and tax experts should study the law to see whether such options are permissible.

Post Retirement Health and other care

It is impossible for any employer, or any individual other than wealthy persons, to build up a fund by retirement which would be sure to pay for all post retirement health and other care for retirees and their spouses. Severe conditions may require millions of rupees for treatment. For example, a person with severe Parkinson's may require medicines costing over Rs 1,000 per day.

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In the current climate of opinion against DB schemes, it is not realistic to expect employers to provide post retirement medical benefits. Some employers continue to do so, others have discontinued these schemes.

However, we at Akhtar & Hasan helped a leading Employer to set up a system by which employees were able to make voluntary contributions. On retirement, they had the option of withdrawing these savings plus accumulated investment income. Or leaving them with the Employer, under a post retirement medical scheme which provides various benefits subject to limits. At death, any unused balance is paid out to the heirs.

Sometimes one is told that post retirement medical scheme can be covered by health insurance. In fact, at the point of retirement no health insurer is going to guarantee provision of life long health care benefits at a fixed premium. At best, a friendly health insurer may agree to provide year to year benefits, at premiums which are not guaranteed, and quoted each year. This is not really a solution. Of course, as long as the health insurer continues to do this, it relieves the Employer of the administrative burden, but still leaves him to face uncertain future costs. And IAS 19 will require actuarial assessment of the long term liability for the Employer.

The Employee's own role

The employee has a vital role to play in providing for his own retirement.

If there is a Provident Fund, then the Income Tax law requires him to contribute to it, otherwise the Employer cannot contribute.

Apart from this compulsory contribution, he can have his own saving plan.

Some employees have the self discipline to save every month. But it helps a great deal if the voluntary saving is deducted from his salary cheque, under some salary savings scheme. There is enormous scope for such schemes to be set up for the employees of large and medium sized employees, by life insurance companies, banks and financial institutions, and asset management companies.

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Own Home

The biggest contribution that a person can make to his retirement is to own his home by that time. People are very conscious of this. Banks and financial institutions got into the home financing act some years ago. But according to the State Bank's 2007-2008 Report, commercial banks slowed down their home financing.

Table 5 shows the break up of Consumer Financing by Banks at end June 2007 and 2008. Unfortunately, only a small proportion goes into financing house purchase.

Table 5: Consumer Financing by Commercial Banks

Item	30 June 2007		30 June 2008	
	Amount Rs billions	% of total advances	Amount Rs billions	% of total advances
House building	53.8	2.3 %	66.9	2.4 %
Transport	105.4	4.4 %	104.5	3.7 %
Credit Cards	42.8	1.8 %	44.4	1.6 %
Durables	1.0	0.0 %	1.7	0.1 %
Personal Loans	142.5	6.0 %	139.3	4.9 %
Total Consumer Finance	345.6	14.5 %	360.2	12.8 %

Personal Post Retirement Health Care Reserve

For Post retirement health care costs, considering the steep increase likely as age increases, a retiree would do well to set aside a proportion of his assets at retirement for this purpose. The investment income on this should be re-invested, so that this "medical reserve" keeps increasing.

Of course, there is no guarantee that the amount would be enough. But something is better than nothing

Whole Life Policy can help to reimburse Health Care costs of last illness

A high proportion of the total medical expenses of a retiree or his spouse is incurred in his or her final illness, during the last 12 months of life. It has been suggested that one way to reimburse a significant part of post retirement medical expense is to buy a Whole Life With-Profits policy a year or two before normal retirement. This will not provide money for the treatment of the last illness, but will provide money after the retiree's death so that at least some part of the medical expense is recovered. Of course, the issue of a Whole Life policy is subject to medical and other tests by the insurance company.

Reflections on investment in ordinary shares

The Companies Ordinance, 1984, read with various SECP notifications, permit direct investment of up to 30% of a company's Provident Fund in ordinary shares. Up to 50% can be invested in ordinary shares through mutual funds, but not more than 20% in any one mutual fund. This 50% is reduced by direct investments made in ordinary shares. The law on ordinary share investment by Pension and Gratuity Funds is not so clear cut.

Some Provident, Pension and Gratuity Funds have invested in ordinary shares, and have suffered valuation losses because of the recent steep fall in share prices. Should these Funds continue investing in ordinary shares? Perhaps the following procedure can be adopted:

The key decision is the target allocation of the Fund among fixed interest securities and ordinary shares. The Trustees have to make this allocation, having regard to the risk appetite of the Fund, and after taking appropriate advice from reputable licensed investment advisers. They have to consider whether or not a well spread portfolio of ordinary shares built up systematically over a period of years is likely to produce higher yields, net of inflation and taxes, than fixed yield investments. At the same time they have to recognise that the market value of ordinary shares can be "all over the place".

If they decide to allocate some proportion (within the legal limit) to ordinary shares, then they face the question of timing. Nobody can say where the market will be one month, or three months, or one year or three years from now. So they should consider whether to build up the target allocation in instalments over a few years through Mutual Funds. If the "dollar average" principle is applied, then when prices are low, more shares are bought. When prices are high, fewer shares are bought.

You should take expert advice on legal, tax and investment matters
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