Executive Summary

This report has been prepared by the World Bank at the request of the Government of Brunei to evaluate policy options for the establishment of a Supplementary Contributory Pension Scheme (SCP) and related life insurance policy in order to supplement the minimum amount currently provided under the Old Age Pension (OAP) to those citizens and permanent residents at age 60 who have contributed to the proposed scheme. The Government has sought guidance from the Bank on other measures which could best align the benefit structure and operational characteristics of the proposed SCP with the existing institutions, namely the Government Pension Scheme (GPS) and the Employees Trust Fund (TAP). The report has been prepared by a World Bank team consisting of staff from its Treasury Group and Pensions team.

This report begins by examining the provision of mandatory pension and survivorship benefits by mandatory pension schemes in Brunei. It has examined the benefit entitlements provided to retirees at different income levels and identified weaknesses in the current policy framework. In an effort to remedy some of these weaknesses, the Government has proposed the introduction of a Supplementary Contributory Pension Scheme (SCP) and a National Life Insurance Policy (LIFT). We have examined the design features and operational requirements of each as well as the anticipated benefit for beneficiaries of both. We have also examined the composite benefit that TAP/SCP contributors can anticipate in retirement based using both metrics of their benefit relative to pre-retirement income as well as relative to average economy wages. Finally we have suggested additional reform measures to consider for the TAP and GPS and thoughts for medium-term policy directions.

Overall framework description. Brunei's mandatory public pension system currently offers arrangements which provide for a smoothing of income from work life into retirement as well as a universal demogrant that ensures that all citizens and permanent residents have a minimum level of support during retirement to ensure against poverty in old age. The Government Pension Scheme (GPS) is a non-contributory scheme offering old-age pension, disability and survivorship benefits to civil servants hired prior to 1993 and all members of the uniformed forces including the military, police and prison guards. The Employee Trust Fund (TAP) is a contributory provident fund providing pension and social security benefits for all public and private sector workers in Brunei and those civil servants who began work beginning in 1993. The TAP provides early withdrawals for housing and preparation for retirement as well as for death and disability. The Old Age Pension (OAP) is a universal demogrant provided to all Brunei citizens aged 60 and above. In addition, a Supplementary Complementary Pension (SCP) has been proposed which would provide an additional annuitized benefit.

Replacement of pre-retirement income. By having a flat demogrant (the OAP) as well as a proposed SCP that provides contribution subsidies to low income contributors, Brunei's combined benefit offers a substantially higher replacement of pre-retirement income for lower-income workers than for upper income workers. Projected combined benefits for an average wage of a 60 year old man who contributes 30 years to the TAP and SCP would be about 48 percent of his pre-retirement income; with a replacement rate of 78 percent for a worker earning 50% of the average wage.

Adequacy in ensuring a minimum standard of living during retirement. The composite support provided by the OAP, TAP and proposed SCP provide for a modest minimum subsistence level or standard of living regardless of lifetime income. A key measure of these pension entitlements is the individual pension divided by average covered earnings for all contributors. The composite flat OAP benefit, the proposed SCP which has a minimum benefit and a cap on covered wages, and the TAP, is a relatively flat redistributive benefit. A man earning an average wage and contributing to the TAP and SCP for 30 years would receive a net benefit equal to 48.1 percent of average earnings of TAP contributors; while a worker earning 50 percent of the average TAP earnings would receive a net benefit equal to 39.0 percent of average earnings. In this way, the combined benefit provides disproportionately higher absolute benefits for lower-income workers at retirement.

Employee Trust Fund (TAP). The TAP is a provident fund providing pension and social security benefits for all private sector workers in Brunei and civil servants who began working beginning in 1993. The TAP has a mandatory contribution rate of 5% of wages for employers and 5% for employees; with 63,718 active contributors of which 35,693 were public servants. The TAP pays out a "dividend rate" based on the rate of return on its investments in a given year which has been positive in real terms each year since 1996. There are six types of withdrawals permitted under the TAP: (i) normal retirement withdrawal; (ii) pre-retirement withdrawal; (iii) survivors' withdrawal; (iv) emigration withdrawal; (v) housing withdrawal; and (vii) incapacitation withdrawal.

TAP policy reform issues. The core weaknesses of the TAP in its current form are:

i. the accumulation at retirement is too low to support a meaningful replacement of pre-retirement income and therefore the scheme on its own does not provide for an effective smoothing of consumption;

ii. the absence of some form of annuitization or phased withdrawal subjects the retiree to investment, inflation and longevity risks during retirement;

iii. there are no special incentives for low-income workers and the so-called unorganized sector to contribute;

iv. the absence of a cap on covered wages subject to mandatory contributions creates incentives for high-income workers to underreport income;

v. the framework for disability and survivorship benefits is withdrawal of accumulated savings which fails to take advantage of the substantial benefits of co-insurance which could be provided by pooling the risks of disability and death;

vi. smoothing of the returns on accumulated assets leads to uncertainty by contributors.

Some of these issues are addressed through the proposed SCP below.

The Old Age Pension. The universal Old Age Pension (OAP) is a demogrant established to provide a minimum living subsistence to all citizens and permanent residents aged 60 and above. The benefit was B$250 per month in 2007 or about 17.8 percent of the estimated average individual covered wage for members of the TAP. The benefit is neither contributory nor means tested.

Supplementary Contributory Pension (SCP). The primary objective of the proposed SCP is to supplement the current benefit provided under the OAP by a minimum of B$150 per month for those individuals that contribute to the scheme. Such a benefit would have the effect of (a) increasing the benefit levels provided through a combination of TAP, OAP and now the SCP, particularly for those TAP contributors with insufficient accumulations at retirement to support a basic annuitized benefit; and (b) the Government matching contribution proposed would create an additional incentive for contribution compliance by low-income workers. Key design features of the proposed scheme would be:

- The annual benefit would be determined based on the account accumulation at retirement at age 60 converted to an annuitized inflation-indexed benefit based on the life expectancy at retirement and projected inflation and real interest rates;
- The benefit would be no less than B$150/month and would be provided at age 60, indexed in the future to the consumer price index;
- Coverage would be limited to current contributors to the TAP who would also be required to contribute to the SCP;
- Contribution requirements of 3 percent of covered wages for employers and employees, respectively of which 2.5 percent would go into an individual account for the supplementary pension and 0.5 percent would be paid as a premium towards a a minimum survivors' benefit;
- The Government would make matching contributions to support lower income workers and provide an incentive for such individuals to contribute. The Government contribution would be B$42.50/month in 2008 for workers with reported incomes of B$500 and under and the matching contribution would be reduced according to a

sliding scale until B$2000 when it would be eliminated. The Government's matching contribution would increase each year in line with the growth in covered wages; and

- Covered wages subject to SCP contributions would be limited to 200 percent of average TAP covered wages for existing active members.

Transition options. Generating sufficient accumulations to support an SCP pension of B$150 per month requires members to contribute for enough time to support such an annuitized or phased withdrawal benefit. The amount of time required to accumulate contributions depends upon the income level of the member. This suggests four potential transition options:

i. The objective of a minimum SCP benefit of B$150/month could be realized only gradually so that much smaller annuitized benefit levels would be provided for those with small account accumulations;

ii. The minimum benefit of B$150/month could be provided immediately with the Government subsidizing those older cohorts that will have insufficient contributions to support such a benefit. In principle, the Government could borrow from the SCP contributors by issuing bonds and, in turn, utilizing some of the proceeds to make the necessary payments to recent SCP retirees;

iii. The minimum benefit could be provided after a vesting period of perhaps 15 years with a Government subsidy to top-up those individuals not meeting the vesting requirements; and

iv. The B$150/month minimum benefit could be provided only on a means-tested basis, applying not only income testing but other means testing variables.

Financing the minimum SCP pension guarantee. Apart from the transition issue is the matter of the financing mechanism which needs to be determined for those individuals whose incomes and/or lifetime contribution density together are insufficient to support the minimum annuitized benefit of B$150 needs to be determined. As currently formulated, the maximum Government contribution of $42.50/month for each SCP contributor would, on its own, be insufficient to support an annuity of B$150/month even in the long run. Moreover, even assuming that a minimum wage worker making B$559/month also contributes 5 percent of his or her income, it will require about 26 years of accumulations in order to support a lifetime indexed annuity of at least B$150/month at age 60. This suggests that a minimum vesting period to receive the minimum benefit guarantee will not only be an issue of transition as the scheme becomes operable but will have to be considered over the long run as well. As with the transition arrangements, setting a minimum benefit creates incentives to underreport income or otherwise to avoid contributions to the SCP.

Annuitization Options. There are three broad options for the annuitization of pension benefits under the scheme: (i) calculate an indexed annuity at retirement and recalculate the benefit each year and have the Government bear the longevity risks, investment and inflation risks; (ii) adopt a phased withdrawal approach where the benefit would be calculated at retirement based on life expectancy and anticipated inflation and investment return assumption then recalculated each year based on the same assumptions plus longevity assumptions; or (iii) a combination of the two, whereby only those meeting minimum balance criteria are afforded one option or the other.

Survivors' benefits – Mandatory life insurance scheme. The core objective of the life insurance scheme is to provide minimum income of B$400/month collectively for the survivors of each SCP contributor during their lifetime and B$150/month after age 60. Benefits would be provided on an annuitized basis through the survivors' lifetime including through retirement. Key design features of the proposed scheme would be:

- Annuitized benefits would be provided based on the accumulation in the SCP account upon the death of the contributor, taking into account the life expectancy of the survivors and projected interest and inflation rates. The insurance fund would then provide any top-up necessary to ensure that a minimum benefit of B$400 is realized for the beneficiaries prior to age 60 and B$150/month after that.
- Premia would be of 0.5% of covered wages for employers and employees, respectively, based on covered wages up to a cap of 200% of the TAP average.
- Eligible survivors would collectively receive the minimum survivorship benefit with the division between survivors according to rules to be determined.
- The benefit would be fully indexed to the consumer price index.
- No retroactive benefits for existing survivors are proposed.
- The difference between the premia revenue and policy payment to top-up survivors' benefits would be held in a reserve fund. Such a reserve fund would accommodate changes in the population structure, mortality incidence, and economic volatility, including inflation and interest rate adjustments and fluctuations in contribution and premia revenues.
- The insurance fund would be subject to an annual actuarial valuation at which time a contracted external actuary would make both a projection of premia income and benefit payments as well as make a recommendation for the minimum level of actuarial reserves to be held to manage both projected costs and anticipated risks. To the extent to which the actuarial reserves exceed those which are determined by the actuary as needed, the Board of Directors of the SCP will have the authority to make an annual distribution from the insurance fund to the SCP individual accounts.

Income testing and dependency criteria. One means of substantially increasing the benefit provided to survivors would be to establish dependency criteria whereby the survivor must meet a number of qualifying criteria for receipt of the benefit.

Additional Pension Policy Issues - Retirement Age. In Brunei, we suggest policymakers focus on a gradual phased increase in the TAP retirement age from 55 to 60 and a similar phased increase for those civil servants remaining in the GPS.

Remaining weaknesses in the TAP. Although the proposed design of the SCP and LIFT go a long way towards remedying many of the weaknesses identified in the TAP, additional reforms are needed to the TAP design in order to strengthen the adequacy and predictability of benefits. These include:

i. Segregation of savings for housing and retirement;
ii. Increasing the retirement age;
iii. Eliminating early retirement ("pre-retirement") withdrawals.
iv. Establishing benefit annuitization;
v. Limiting covered wages subject to contributions; and
vi. Earmarking voluntary supplemental contributions to old-age retirement.