Social Insurance Issues in the Gulf: Accompanying Paper

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Introduction to the Gulf

With all of the current problems in the Gulf, particularly with ISIL and AQAP (Al Qaeda Arabian Peninsula), you could be forgiven for not thinking that pensions would be particularly high up on the Governments' agenda. However, the pension deficits in the region are enormous and are storing up huge problems for future generations; so they probably should be relatively high up on their agendas after all.

My slide presentation (and accompanying paper) introduces the pensions and social security problems in the Gulf Cooperation Council ("GCC"), namely in Oman, Bahrain, Qatar, Kuwait, United Arab Emirates and Saudi Arabia. I will provide a high level over-view of what pensions provision exists in the region (i.e. the social insurance schemes for the gulf nationals and the end of service benefits that are available for ex-pats) and I will discuss their current challenges. Then I will discuss two "opposite ends of the spectrum" case studies, in Abu Dhabi and Oman, including a particular focus on how they are trying to overcome their pensions problems.

Pension provision in the GCC:

- **Social insurance schemes for gulf nationals.**
  - **Structure and original aims**

There are social insurance funds in all of the GCC states and they were set up with the aim of providing social protection and social welfare to all citizens (in other words, only gulf nationals).

They are all defined benefit, they are typically compulsory and typically provide coverage for all citizens in both the public and private sectors, the self-employed, and these people's beneficiaries. Although there are a few slight differences across the region, these schemes are also generally the only pillar of pension provision and thus people have high expectations for the income replacement ratio.

The oldest social security fund is only 46 years' old (in Saudi Arabia), and the youngest schemes are as new as only 15 and 13 years' old, so managing and funding these social security arrangements is presenting some relatively new problems for the GCC.

  - **Benefits**

The schemes provide a slightly wider range of benefits than are typical in Europe. As well as providing a pension in "old age", and insurance against incapacity and death, they also provide other social benefits such as retirement loans, funeral grants, and marriage grants for daughters and sisters.

And the benefit levels themselves are extremely generous: the income replacement ratio is as high as 100% in Qatar (although I understand this is currently under review) and 88% in Bahrain for example. In Oman and the United Arab Emirates ("UAE") the income replacement ratio is 80% and in Saudi Arabia it is 75%.

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Furthermore, members typically receive their full, unreduced, pensions at what I would consider to be very young ages! In Qatar a member only needs 20 years' service to receive their full pension, which means that it can be taken unreduced from age 40! In the Oman social security scheme and in the UAE, for example, members only require 25 years' service to receive full pension.

The arguably excessive generosity of the schemes primarily comes from the fact that these schemes were originally set up as a means of distributing the countries' oil money. In addition, legislation in this region is typically based on underlying very paternal religious principles to look after everyone. But this comes at a cost!

The social security arrangement in Kuwait seems to be the least generous in the GCC as it provides an income replacement ratio of 65% (this is clearly a very similar proportion to the 2/3rds target that many schemes in the UK have). The other key difference between Kuwait and the other GCC social security funds is that Kuwait fully funds its scheme.

- **Funding issues and current financial position**

Even looking across the whole world, it is relatively rare to find a social security arrangement that is fully funded. Of course in the UK we use a "Pay As You Go" arrangement. All the other arrangements in the GCC (bar Kuwait) only partially fund their schemes.

The primarily reason why most social security arrangements are not fully funded is that governments are meant to be able to provide a much stronger covenant than any private company could. In theory, were any government not able to pay its pensions due one year then it could raise taxes to meet the difference needed. However interestingly there is no (or very little) income tax in the GCC so "raising taxes" as a means of meeting pensions payments may not be as straightforward as it seems elsewhere. This raises the interesting question as to what these schemes will do when (or if) these governments run out of oil money.

However although most social security arrangements across the world are not fully funded, they are typically still funded to a pre-determined benchmark, which is set out in their legislation (albeit different countries will have different benchmarks). Usually these benchmarks will be along the lines of requiring the assets to cover the annual benefit expenditure by a certain number of times. Or that the reserves will remain positive for a certain number of years or that the deficit doesn't exceed a certain percentage of GDP.

I understand that one of the main reasons why the social security schemes in the GCC have got into such severe financial difficulty so early on in their lifetimes is that there was no identification of any funding benchmarks when these schemes were first set up. Clearly this has the result of taking the focus or emphasis off reviewing the schemes' funding levels (because you don't know what you're funding to or whether you've even already reached that point).

Furthermore, I understand that in the early years there was a general misunderstanding of the definition of surplus; the net cashflow into schemes each year was misunderstood for a surplus in that year, and was typically spent, which has also led to poor funding positions.

- **Current Financial and Demographic Challenges**

The financial problems, coupled with falling fertility rates and rising life expectancies, have led the GCC to conclude their schemes are unsustainable. The GCC therefore has the challenge of how to reform these schemes such that they are stable and sustainable going forwards, particularly given their political constraints.

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Falling fertility rates: example

Around 30 years' ago, Oman used to have a total fertility rate ("TFR") of around 8 children per woman! At this time the UAE was also very high at around 5 children per woman. Data from the World Bank shows that these rates have been plummeting in these two countries over the last 30 years, with the TFRs of Oman and UAE now at only around 3 and less than 2 respectively. Indeed the TFR in the UAE is actually slightly lower than in the UK now.

This dramatic fall in the TFRs in these two countries has contributed to the rise in their average ages.

Rising life expectancies: example

As I previously mentioned, people in the GCC tend to draw their pensions from young ages. This problem is also coupled with the fact that we are also seeing significant rises in life expectancy in the region, meaning of course that pensions need to be paid out for longer, which increases costs.

Although life expectancy in Oman and the UAE is lower than that in the UK, the rates of increase in life expectancy in these two countries have been far more rapid in recent years. For example, life expectancy has increased approximately three times faster in Oman compared to the UK, over the last 50 years.

The effect of both rising life expectancies and falling TFRs has been to reduce the number of contributors per pensioner. This effect has already been relatively dramatic in the UAE. According to data from their government, in 2000 there were 24 contributors per pensioner but now this has already fallen to only 5 contributors per pensioner; if this fall continues, this will definitely be of concern for the government of the UAE.

Interestingly, however, the populations of gulf nationals in each of the GCC countries are relatively small compared to the total populations: so we are not talking about that many people. For example in the UAE, Emirates only account for around 11% of the total population.

So there are a lot of people who live in this part of the world who are not getting this social insurance provision.

- **Ex-pats' provision: End of Service lump sums**
  - **Current challenges**

The number of ex-pats is significant and the majority of these people will not be earning anything like enough to make their own private pension provision.

There are labour laws which act to protect ex-pats to an extent; anyone in formal work is entitled to a modest End of Service lump sum benefit when they leave their employer. This lump sum is based on the employee's final salary and their years of service. In other words, this arrangement is not dissimilar to our cash balance plans in the UK.

The crucial difference is that these schemes are unfunded which means ex-pats have no protection on the insolvency of their employer. And it is difficult persuading companies in the region on the advantages to funding. One of the main advantages to funding for UK plc is that it ultimately makes pension provision cheaper because schemes benefit from investment returns. However if a company in the oil industry (for example) is making (say) ten or twenty fold returns using that money elsewhere in the business, it is understandable why they do not want to put the money into pension pots instead!

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The vulnerability of ex-pats on employer insolvency, with regard to these benefits, is on many of the governments' agendas. Some of the governments have been considering incorporating ex-pats into their social security arrangements for example. And some are looking at introducing insured End of Service arrangements.

- **Pros and cons of insured arrangements**

The key benefit of an insured End of Service arrangement is that employees would be far better protected. The other key advantage for employees (over having a pension provided through the social insurance arrangement) is that they can bring their funds home with them, if they retire in their home country (which is typical).

From the perspective of governments, one of the key advantages is that the number of complaints from ex-pats who have lost their benefits would clearly reduce!

Employers in the region are likely to be the most difficult to persuade on the benefits of insuring End of Service arrangements. That said, there are a number of advantages from their perspective too. In particular having a separate, funded, arrangement is usually considered to be good governance and this will be important to any company who wishes to play in the global markets.

The lack of protection afforded to ex-pats, the discrepancy in terms of the level of benefits awarded to ex-pats compared to the Gulf nationals and the sheer number of ex-pats in the region, means that this is currently a very "hot topic" in the GCC.

Case study: Abu Dhabi Retirement Pensions & Benefits Fund

- **Members and Beneficiaries**

The Abu Dhabi Retirement Pensions and Benefits Fund was started in 2000, and covers almost all Emirates (i.e. everyone from Government workers, to the self-employed, and of course their beneficiaries). This structure (whereby one scheme covers everyone) is actually very unusual.

The scheme is also compulsory.

- **Benefit levels**

The key provision terms are an accrual rate of 3.2% p.a. and members can retire unreduced at age 45 after 25 years of service (despite the official "normal retirement age" of 60 for men, and 55 for women).

For those members who do not retire after their 25 years' service, although they have hit their cap of 80% accrual of their salary, these people continue to accrue on another benefit structure (effectively a cash balance structure).

The minimum pension is equivalent to circa £13,000 a year, which would be considered extremely generous in a UK context!

There is also a very large potential number of beneficiaries per member (which presents certain challenges when modelling the scheme!). As well as beneficiary payments to a spouse and children up to age 21 (or 26 if the child is in full time education), this scheme also pays out to brothers, sisters,

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parents and even grand-children in some cases. Further, where the daughter / sister / grand-daughter is unmarried then the pension can continue for the rest of her life.

The TFRs presented earlier demonstrate that we are currently talking about a lot of beneficiaries per member! This serves to provide another reason as to why the generous benefits are *so* expensive to provide.

- **Challenges**

The contribution rates written into law in respect of accrual are currently the following:

- 5% from the Employee;
- 15% from the Employer; and
- 6% from the Government.

Given the generosity of the benefit level, and the number of potential beneficiaries, this contribution rate seems unlikely to be enough. Indeed in the current climate it seems likely to be woefully insufficient.

These rates were initially set up in 2000 when, at the time, they were designed to ensure the build-up of reserves that would last 75 years. However, as you saw from the changing demographics earlier, benefit provision has been getting more and more expensive and thus the assets will now no longer be likely to last until 2075.

Abu Dhabi is of course one of the wealthiest countries in the GCC; in fact it has one of the largest sovereign wealth funds in the world. In theory this could suggest that Abu Dhabi could move to a "Pay As You Go" model once the assets have been depleted. However, it is preferable to reform the scheme so that going forwards the scheme itself is entirely self-sustainable.

As such, the Abu Dhabi government is currently reviewing all their options with regard to benefit reform:

- **Reform Opportunities**

Reform options include introducing a greater salary averaging period, reducing the accrual rate or the maximum cap on accrual, reducing the lump sum benefits on death and work-related injury or capping salary growth, for example.

My own view is that increasing the earliest age at which benefits can be taken unreduced or increasing the minimum required years of service, is likely to be a key reform opportunity.

Case study: Oman

- **Various pension schemes in Oman**

Oman is at the opposite end of the spectrum, compared to Abu Dhabi, with regard to pensions. Firstly it is the poorest country in the GCC whereas Abu Dhabi is one of the wealthiest. In addition, Oman has a number of different pension funds, as opposed to the one scheme which covers everyone. And these schemes are typically in a worse financial position compared to in Abu Dhabi.

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Oman has eight public sector schemes; two of these are for civil servants and six are for the military, or military related, staff. In addition, there is one social insurance fund for almost all private sector workers called the Public Authority for Social Insurance ("PASI").

All private sector employees are automatically enrolled into the PASI scheme, and regardless of whether employees change job (or even industry), they will remain in the PASI scheme.

The exception occurs where a private sector pension scheme provides more generous benefits than those under PASI, and there are only two companies in Oman which currently fall into this bracket.

The Ministry of Finance tries to regulate all the pension schemes in Oman, but with limited success!

- **Aggregate financial position**

The Ministry of Finance estimates that there are approximately 1 million people enrolled in one of the pension schemes across Oman (in aggregate this is much larger than Abu Dhabi). PASI is the largest of the individual schemes with about 200k members, and the main civil service is the next largest with 160k members.

In 2007 the Ministry of Finance announced that the combined deficit was around 4 billion OMR (around circa £7 billion) however their view is that the 2010 valuation is likely to show a considerably increased deficit – likely to be around 10 billion OMR (or circa £17 billion), with the schemes' funding levels typically around 30% - 40%.

The combined deficit is therefore likely to be around a third of Oman's GDP, which is arguably a worse financial position than in the UK.

- **Ministry of Finance as a Regulator**
  - **Limitation of powers – no regulatory regime**

Unfortunately it is somewhat more complicated to bring about a pensions reform in Oman, compared to in Abu Dhabi, mainly due to the very limited powers of the Ministry of Finance.

There is no real regulator of the pension funds in Oman:

The Ministry of Finance is provided with data from all the pension schemes (and as such in 2007 was able to perform its vey first aggregate valuation of all the schemes). And it also has the power to 'refuse' schemes' requests for new money, however ultimately all members' benefits must be paid in full so this power is somewhat a 'faux amis'.

  - **Strength of pension schemes' Boards**

Schemes are run by Boards who very often consist of members of the scheme itself. The Boards therefore usually have an interest in keeping benefits in the scheme high, and certainly have no incentive to cut benefit levels.

Boards usually have no requirement to consult with the Ministry of Finance before introducing a benefit enhancement (or to carry out any form of cost-benefit analysis). As such, there are a number of examples of cases of benefit augmentations and enhancements in some schemes in Oman, which the Ministry of Finance had no power to block, and which have ultimately made the aggregate funding position worse!

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One such example is in the Diwan Pension Scheme where members can now purchase an additional 5 years of service for only the employee share of the ongoing contribution rate. This is clearly well below the aggregate cost of accrual and thus it is the Ministry of Finance who must pick up the tab.

When the Ministry of Finance has attempted to propose benefit reforms in the past, these have been blocked by the Boards. Ultimately it is only the Sultan who would be able to force through a reform, but he is unlikely to want to do this! Indeed one of his techniques for quelling the Arab Spring in Oman so rapidly, and so successfully, was to announce an increase to the pension accrual rate!

- **Opportunities and aims**

The Ministry of Finance's top aims over the coming years are as follows:

- To reform the Boards such that they become independent. The Ministry of Finance considers that Boards who do not have such conflicts of interest will be likely to make better decisions with regard to the future of the schemes;

- To increase the age at which you can retire with an unreduced pension. As life expectancy is increasing at such a rapid rate, there seems to be a general consensus among government that the current retirement age of 45 is too young. However, persuading the general public that this is a fair change will present a challenge!

- To bring in new hires on a reduced accrual rate compared to the current employees. In my opinion, this is unlikely to work until the labour laws have been reviewed as at present Omani employees have lots of employment rights including the fact that they cannot be dismissed from their employment (except under extreme circumstances).

- To introduce a nationwide communication drive, to inform the general public about the trends in rising life expectancy and the associated increased pension costs. This could be successful but will need to be implemented over many many years before it will be effective.

Summary

There appears to be a strong paternal culture in the GCC and, due to the fact that the social insurance funds are (usually) the only pillar of pension provision and were set up effectively as a means of distributing oil money, the level of benefit provision is extremely generous.

However the schemes are typically unsustainable and so there is plenty of work for actuaries in the region on benefit reform. In addition there is work for actuaries on improving the ex-pat provision as well.

Key References:

- Financing of pension schemes, ISSA presentation, George Psaras
- Social Security Systems in the GCC, i.e. Muhanna & co
- Demographic data from the World Bank
- Demographic data from the United Nations, Department of Economic and Social Affairs (Population Division)
- World Social Security Forum, 31st ISSA General Assembly (Soliman S. Al-Humayyd)
- The Abu Dhabi Retirement Pensions & Benefits Fund website

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