

# PERA Opportunities for the Life Insurance Industry

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## Salient Features

## PERA Law

- RA No. 9505 - an act establishing a provident personal savings plan, known as the Personal Equity and Retirement Account (PERA)
- Signed by GMA 08-22-08
- Objectives:
  - Establish legal and regulatory framework for voluntary personal retirement plans
  - Promote capital market development
  - Enhance savings mobilization
  - Contribute to long-term fiscal sustainability through long term financing and reduction of social pension

## PERA Participants

- Contributor
- Administrator
- Custodian
- Investment Manager

## Contributor

- Any Filipino with the capacity to contract and possesses a tax identification number.
- The Contributor establishes and makes contributions to a PERA.
- The Contributor, directly, or through an Investment Manager, makes investment decisions for his PERA

## Administrator

- Accredited by BIR whose primary responsibility is overseeing PERA, including
  - conduct of client suitability assessment and formulation of investment policy consistent with risk profile of Contributor
  - provide information to the Contributor on PERA Investment Products with emphasis on the specific category of products corresponding to the risk profile of the Contributor
  - reporting on contributions, income, expenses,\* withdrawals and on the account and value of investments,
  - enforcing PERA contributions and withdrawal limits,
  - collecting appropriate taxes and penalties for the government,
  - securing BIR Income Tax Credit Certificates for the Contributor,

\* Expenses include total fees and charges paid to the Administrator, Investment Manager and Custodian

## Custodian\*

- Provides services in connection with the custodianship of funds and securities comprising the PERA investments.
- Responsible for receiving all funds in connection with the PERA
- **Maintains custody of all original securities, evidence of deposits or other evidence of investment**
- Reports to the Contributor and the concerned Regulatory Authority at regular intervals all financial transactions and all documents in its custody under a PERA.
- Limited only to banks and trusts entities

\* Separate and distinct entity unrelated to Administrator, BSP-accredited

## Investment Manager

- A regulated person or entity authorized by a Contributor to make investment decisions for his PERA.
- Assumes fiduciary duty and responsibility for PERA investments.
- Acts with utmost fidelity by observing policies directed towards confidentiality, scrupulous care, safety and prudent management of PERA funds.
- **An Investment Manager shall not be allowed to recommend or sell its own investment products or that of its subsidiaries and affiliates.**
- The same entity may act as both Administrator and Investment Manager, **provided that the entity possesses a trust license.**

## PERA

- A Contributor may create and maintain a **maximum of five (5) PERA, at any one time** *Provided, That the Contributor shall designate and maintain **only one (1) Administrator** for all his PERA*
- The Contributor has the option to change the Administrator
- **An administrator is obliged to present all available product offerings, with emphasis on the products suited to the Contributor.**
- PERA products must be pre-qualified by Regulator

## PERA Account

- Requirement of separate account for PERA investments\*
- All income earned from the investments and reinvestments of the **maximum amount allowed** for PERA is tax exempt.
- Non-assignability of PERA assets

\* PERA assets shall not form part of general assets of the Administrator / Custodian for purposes of insolvency

## PERA Contributions

- Maximum annual contribution to PERA is P100,000 per Contributor\*
- **Any excess contribution above the maximum limit shall not be entitled to a tax credit of five percent (5%) and the investment income made therefrom is not exempt from tax.**
- A private employer may contribute to its employee's PERA up to the amount allowable to the Contributor
  - Provided employer is compliant with SSS contributions and retirement pay law
  - Provided contributor retains control on investment decisions on his PERA

\* For Overseas Filipinos, the max contribution is double the limit. Any excess contribution is no longer subject to 5% tax credit.

## PERA Distributions

- Optional at Age 55 provided contributions to the PERA for at least five (5) years have been made.
- Settlement in either lump sum or pension for a definite period or lifetime pension
- Complete distribution at time of death of Contributor
- Early withdrawal without penalty is allowed
  - For payment of accident or illness-related hospitalization in excess of thirty (30) days
  - For payment to a Contributor who has been subsequently rendered permanently totally disabled as defined under EC, SSS and GSIS

## PERA Investment Products

- Refers to a unit investment trust fund, mutual fund, **annuity contract, insurance pension products**, pre-need pension plan, shares of stock and other securities listed and traded in a local exchange, exchange-traded bonds or any other investment product or outlet which the concerned Regulatory Authority may allow for PERA purposes:
- **PERA investment products must be non-speculative, readily marketable, and with a track record of regular income payments to investors.**

## Possible Product Offerings for Life Insurers

## Recap

- Approved products
  - UITFs
  - mutual funds
  - **annuity contracts**
  - **insurance pension products**
  - pre-need pension plan
  - shares of stock and other securities listed and traded in a local exchange
  - exchange-traded bonds
  - others approved by Regulatory Authority

## Other Considerations

- Non-speculative, readily marketable, and with a track record of regular income payments to investors
- Administrators and Investment Managers are required to provide the Contributors minimum information on the nature and risks of each category of PERA Investment Products (Product Specific Risk Disclosure Statement) where the Contributors may wish to invest in.
- Administrators reporting on contributions, income, **expenses,\*** withdrawals and on the account and value of investments.
- Requirement of separate accounts for PERA Assets

## Typical Insurance Pension Products

- Endowment products with or without anticipated endowments
  - Non Participating
  - Participating
- Variable Universal Life Policies
  - Regular Pay
  - Single Pay
- Insurance products have unique advantage over other PERA product providers in the sense that death benefits may be offered – guaranteeing beneficiaries that the PERA proceeds in case of death of the Contributor will not be lower than contributions

## Endowment (Pension) Products

Criteria	Non-	
	Par	Par
Approved PERA product list	TBD	TBD
Non-speculative	Yes	Yes
Readily marketable	No	No
Regular income payment	Yes	Yes
Nature of Risk	Low	Low
Expense	High	High
Separate Account	No	Yes*
Special requirement	U/W	U/W
Value at time of placement	zero	zero

\* Typically is separate from general account but may contain provisions for undistributed future dividends

## Analysis of Endowment Products

- May not be suited as a PERA product as it is currently designed
- Non-segregated accounts are not allowed under PERA
- Build up of value under the plan takes so long due to high acquisition expenses
- Will pale in comparison with other competing PERA products
- Underwriting is an unnecessary deterrent

## An Alternative to Endowment Products

- Guaranteed Investment Contracts (or GICs)
- Products offered by insurers that provide a guarantee of principal and accumulated interest.
- Most provide a guarantee on interest earnings or a minimum rate of return over a specified period.
- Similar to CTDs that may be purchased at banks.
- Sometimes called fixed income fund, stable fund, guaranteed fund.
- Maturity period is generally 1 to 5 years (with a few extending up to 10 years).

## GICs

- At maturity date, GICs may be renewed at then prevailing interest rate
- **Insurer takes market, credit and interest rate risk on the investment portfolio**
- Insurance company makes the guarantee, so if insurer fails, there could be a default on the guarantee
- Popular in periods of high interest rates

## Types of GICs

- Zero Coupon
  - offers guaranteed and predetermined return on all funds under the contract at the end of specified period
  - some allow for withdrawals at book value
- Fixed or variable
  - Fixed GICs offers guarantees on principal and predetermined interest on funds invested. Returns may be paid out regularly or at maturity date.
  - Variable GICs usually offer a guaranteed rate only for year 1 and succeeding years are based on floating interest rates subject to a minimum interest rate guarantee.

## Pros and Cons of GICs

- Generally safe\*, and usually pays higher returns compared to CTDs and money market funds.
- In the Philippines, some products are directly linked to credit risk other than the insurer.
- Good starting point especially for novice investors who may not be used to gyrations of bond and equity funds.
- Provides a foundation for investment portfolio to shield against volatility of equity and bond markets.
- Usually incorporates early exit fees .
- May not be the best fund for long term capital build-up – especially in a low interest rate environment.

\* While not insured (by PDIC in the case of the Philippines) like bank CTDs, GICs are commonly backed by general credit of the insurer.

## GICs

Criteria	GICs	End*
Approved PERA product list	TBD	TBD
Non-speculative	Yes	Yes
Regularly marketable	Yes	No
Regular income payment	Yes	Yes
Nature of Risk	Low	Low
Expense	Low**	High
Separate Account	Yes	No
Special requirement placement	None	U/W zero
	FV	

\*Based on non-par endowment plans

\*\*Typically low but may have exit fees for early withdrawal

## VUL Products for PERA

Criteria	Regular	Single
Approved PERA product list	Yes	Yes
Non-speculative	Yes*	Yes*
Readily marketable	Yes	Yes
Regular income payment	Yes	Yes
	Depends	Depends
Nature of Risk	On Fund	on Fund
Expense	High	Low*
Separate Account	Yes	Yes
Special requirement	U/W Premium	U/W Premium
	net of charges	net of charges
Value at time of placement	charges	charges

\*As long as aligned with risk profile of PERA Contributor

\*\*Current premium charge levels are high relative to UITFs or mutual funds

## Regular Pay VUL Products

- Regular pay products are clearly not be suited as PERA investment
  - High level of premium charges will be a product suitability issue
  - Product will pale in comparison when ranged against other PERA products
  - Underwriting requirements may be viewed as an unnecessary burden by Contributors

## Single Pay VUL Products

- Single pay products may need some tweaking
  - introduction of new funds to take advantage of tax privileges of PERA (particularly fixed income investments held)
  - need to significantly reduce, if not eliminate, premium charge and instead impose an early exit fee
  - simplify, if not totally, dispense with underwriting requirements
    - guaranteed acceptance
    - refund of charges for death within 2 years other than from accidental means
    - use of guarantee insurability options
  - provisions to allow for subsequent contributions (so as to avoid issuing policies regularly)
  - may need to consider monthly contributions, esp. where employer contributes
  - above enhancements will place the attractiveness of VUL Single Pay products at par with UITFs and MFs with the added advantage of a death benefit

## Group VUL PERA Product

- A group VUL contract may also be considered
  - master policy to cover Contributors of an Administrator
  - master policy or supplementary agreements may cover employees of Employers who contribute to their employees PERA (specifying fund choices, appointment of fund manager, portability within affiliated companies, terms of employer contributions such as matching limits to employee contribution, etc)
  - Allows ease of administration from insurers

## Variable Annuities as an Option

- Contract under which the insurer agrees to make periodic payments to annuitant, beginning either immediately or at some future date.
- Consideration is either a single purchase payment or a series of purchase payments.
- Like unit linked products, several investment options may be available.
- Value of the investment is dependent on the performance of the investment option selected.
- Death benefit is usually paid if annuitant dies before commencement of payments (typically at least an amount of purchase payments).

## New PERA Product - Annuities

- The defining characteristic of all annuity contracts is the option for a guaranteed distribution of income until the death of the person or persons named in the contract.
- However, the majority of modern annuity customers use annuities only to accumulate funds and to take lump-sum withdrawals without using the guaranteed-income-for-life feature.

## Variable Annuity

- Designed to be long-term investments, to meet future financial needs (e.g. retirement).
- Not designed for meeting short-term goals due to taxes (on PERA early withdrawals) and possible charges (or loads, whether upon entry or exit).
- Special licensing is required in US to sell VA
- Consists of 2 phases
  - Accumulation Phase
  - Payout Phase

## How VA operates

- Accumulation Phase
  - Purchase payments may be fixed in advance or flexible
  - Purchase payments are allocated to fund options (net of applicable fees)
    - Money Market Funds (not common)
    - Bond Funds
    - Equity Funds
    - International Funds
    - Fixed Income Funds (GICs, similar also to PDFs)
  - Transfer amongst allowed family of funds is allowed subject to any applicable charges
  - Death benefits are usually granted
  - Surrenders may be subject to applicable charges and taxes
  - During this phase, the VA is practically no different from a VUL

## How VA operates

- Payout Phase
  - Fund value may be paid out in lump sum at payout phase (not the typical annuity as we know) or as stream of regular payments
  - Options for those receiving stream of regular payments
    - Fixed term or during designated annuitant's lifetime
    - Fixed amounts or varying amounts, depending on fund performance
    - Fixed Income Funds (much like PDF)
  - Transfer within family of funds is allowed subject to any applicable charges
  - Surrenders may be subject to applicable charges and taxes
  - Some annuities do not allow withdrawals once regular payments start (for reasons of anti-selection and ALM processes)

## Additional Features

- Fund Options
  - Common Options
    - Bond Funds
    - Equity Funds
    - International Funds
  - Life Cycle Funds (also known as Target Date Funds)
    - special type of balanced fund whereby the mix of an asset class in a fund's portfolio is automatically adjusted during the course of the fund's time horizon.
    - automatic portfolio adjustment run from a position of higher risk to one of lower risk as the investor ages and/or nears retirement.
    - convenience to investors of putting their investing activities on autopilot through the use of just one fund

## Life Cycle Funds

	Years	Neutral Asset Allocation			Portfolio
		Stocks	Fixed Income	Short Term	
<b>Years to Retire</b>	>30	90.0%	10.0%	0.0%	100.0%
	25	85.0%	15.0%	0.0%	100.0%
	20	80.0%	20.0%	0.0%	100.0%
	15	75.0%	25.0%	1.0%	101.0%
	10	70.0%	27.0%	3.0%	100.0%
	5	60.0%	35.0%	5.0%	100.0%
<b>Retirement</b>	0	55.0%	37.5%	7.5%	100.0%
<b>Years post Retirement</b>	5	50.0%	40.0%	10.0%	100.0%
	10	40.0%	45.0%	15.0%	100.0%
	15	30.0%	50.0%	20.0%	100.0%
	20	20.0%	55.0%	25.0%	100.0%
	>20	10.0%	60.0%	30.0%	100.0%

## Additional Features

- Fund Options
  - Money Market Funds
    - temporary parking facility during volatile periods
    - gained significant ground beginning 2007
    - used for more effective dollar cost averaging

## Additional Features

- Fund Value used at Maturity Date
  - Common benefit is total fund value based on NAVPUs
  - High watermark funds
    - highest NAVPU attained provided:
      - there are no withdrawals up to maturity date
      - any dividend distributions are automatically reinvested
      - withdrawal occurs on maturity date
      - highest NAVPU is adjusted for any dividend credits and extraordinary charges.
    - withdrawal on any other date is based on NAVPU.

## Additional Features

- Guaranteed Minimum Death Benefit (GMDB)
  - Higher of Fund Value or
    - Total purchase payments made less withdrawals
    - Roll up of purchase payments at minimum rate of return
    - Highest fund value during the specified anniversaries
    - Higher of roll up or maximum anniversary value
- Loyalty Bonus
  - Bonus is added to the Fund Value based on percentage of fund purchases usually at the end of certain periods (usually 10<sup>th</sup> year and every 5 years thereafter) provided annual target fund purchases are completed.

## Other Features

- Guaranteed Living Benefit\*
  - Guaranteed minimum income benefit (GMIB, a guarantee that one will get a minimum income stream upon annuitization at a particular point in the future)
  - Guaranteed minimum accumulation benefit (GMAB, a guarantee that the account value will be at a certain amount at a certain point in the future)

\* May be likened to Settlement Options either as SCNI or SCI since availment of annuity is at maturity date if lump sum is not elected

## Other Features

- Guaranteed Living Benefit
  - Guaranteed minimum withdrawal benefit (GMWB, a guarantee similar to the income benefit, but one that doesn't require annuitizing)
  - Guaranteed-for-life income benefit (a guarantee similar to a withdrawal benefit, where withdrawals begin and continue until cash value becomes zero, withdrawals stop when cash value is zero and then annuitization occurs on the guaranteed benefit amount for a payment amount that is not determined until annuitization date.)

## VA Charges

- Types of Charges
  - Surrender Charges
    - Usually a declining percentage of amount withdrawn
    - Usually extending between 6 to 10 years
    - Similar to back-end sales load for mutual funds
  - Mortality / Morbidity Charges
  - Administrator's Fees
  - Investment Management Charges
  - Other Fund Expenses (incidental costs such as brokers commissions, stock transaction taxes, etc.)
  - Fees for Special Features and Guarantees
  - Others – initial sales loads, transfer charges, etc

## Pros and Cons of VA

- Has the flexibility of VUL during the accumulation phase – fund choices, fund transfers
- Generally no underwriting required at plan inception
- Optional death benefit ensures proceeds to beneficiaries are not lower than contributions
- Uniquely offers a host of annuitization options (that may be customized) for the Contributor from the PERA proceeds
- Costs for various options offered under VA may impact relative returns

## Opportunities in PERA

## US Experience – 401(k) Plans

- 401(k) plans are mainly employer-sponsored retirement plans whereby employees may elect to have a portion of their wages paid directly into their individual 401(k) account, which is managed by the employer.
- As a benefit, the employer can optionally choose to "match" part or all of the employee's contribution.
- Contributions are on a pre-tax basis, investment income earned by the 401(k) account are exempt from taxes while distributions are subject to the normal tax on ordinary income at retirement (age 59.5 years)
- There are minimum required distributions at the latter of Age 70.5 or April 1 following date of retirement

## US Experience – 401(k) Plans

- Amendments in law to include 401(k) in 1978
- Effectivity date: January 1, 1980
  - By 1983, more than half of large firms offered or were considering to offer 401(k) plans
  - 1998 law allowed employers to have all employees contribute a certain amount to 401(k), unless employee opts not to participate
  - **Mid 80s: 8m participants (7.5% of employed) and \$100B in AUM**
  - **2006: 70m participants (representing 48.0% of employed) and over \$3 trillion in AUM**
  - **AUM CAGR for 21 years from mid 1980 stood at 17.6%**
- Contribution Limit: \$15,500 in 2008, \$16,500 in 2009 and 2010

## PERA Opportunities

- Filipinos employed on a full time basis number 21.7m as of April 2010 according to the recent NSO statistics.
- This figure has reflected a compounded annual growth rate of 1.7% over the last 10 years
- Using a varied set of assumptions, which I think are conservative, as to percentage take up for contributors, average contributions to PERA, historical growth of fully employed labor force, inflation on maximum contributions and average fund value returns the PERA Opportunity is enormous.
- **Yearly contributions may range from P7B to P12B by year 5 and P29B to P57B by year 10.**
- **AUM may reach P16B to P27B by year 5 and P125B to P249B by year 10.**

## Next Steps

- Identify entry strategy to this huge opportunity
  - Is there a first mover advantage?
  - If so, what is the best entry strategy?
- What are the KSFs for this new opportunity?
  - Distribution
  - Fund Performance
  - Product and Fund Choices
  - Brand
  - Technology
  - Relationship with Administrators and Investment Managers
- What will be the process flow for PERA and how does one maximize its resources for this opportunity?

## Next Steps

- What structural adjustments may have to be put in place to take advantage of this opportunity?
  - What systems will have to be put in place to act as an Administrator?
  - What role will agents or independent financial advisors play?
  - What products are best suited for this opportunity?
- How does one deal with the major stakeholders?
  - Administrators
  - Investment Managers
  - Employers
  - Contributors
  - Regulators

## Next Steps

- What about competition not only amongst insurers but also primarily with banks and mutual fund companies?
  - Are the insurers ready for a head to head battle with banks on this new opportunity?
  - What is the industry's sustainable competitive advantage or key differentiation strategy to navigate successfully?
- The foregoing are but some of the considerations as insurers reinvent themselves for the challenges brought about by opportunities under PERA.

## Summary

## Summary

- The Objectives of PERA are:
  - Establish legal and regulatory framework for voluntary personal retirement plans
  - Promote capital market development
  - Enhance savings mobilization
  - Contribute to long-term fiscal sustainability through long term financing and reduction of social pension
- The potential under PERA is enormous for banks, asset management companies and insurers, among others.

## Summary

- New product offerings may have to be explored by insurers to address this opportunity.
- In navigating through this opportunity, new alliances will be built – with Administrators and Investment Managers, in particular.
- The existing business model for insurers may have to be redefined – at least for this particular opportunity.

## Final Word

**We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten.  
Don't let yourself be lulled into inaction.**

**Bill Gates**



Thank You