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Challenges and First Steps in Shariah-Compliant Pension Frameworks

By Safder Jaffer and Simon Heborn

There is an increasing need for pension provision in many Islamic countries. There are special challenges in developing Shariah-compliant pension frameworks. In this article, we identify these challenges and take the first steps in proposing how they may be overcome.

FIGURE 1
Goverment Pension Benefit Payments ($billions)

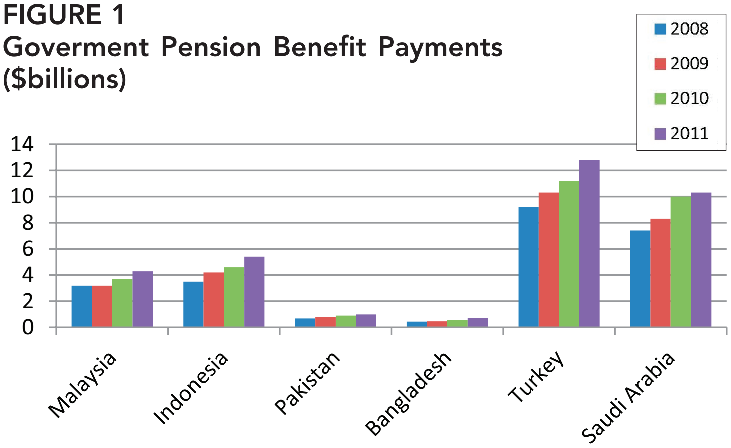


FIGURE 2
Key Data on Selected Muslim Majority Countries

Selected Muslim majority countries	2012 per capita income (USD)	Savings rate as % of GDP	Mid-2012 population (millions)	Population growth rate	Median age of population (years)	Old age support ratio - 2012	Old age support ratio - 2050	Labour force participation rate	65+ population (millions)	Life expectancy males	Life expectancy females	Retirement age
Malaysia	10,000	35%	29	1.60%	27.1	13	4	65%	1.5	72.0	77.0	60
Indonesia	3,200	32%	248	1.04%	28.5	12	3	68%	15.1	70.0	74.0	55
Pakistan	1,155	20%	179	2.10%	21.9	14	7	54%	7.2	64.5	68.3	60
Bangladesh	838	26%	153	1.37%	23.6	14	4	71%	8.0	68.2	72.0	59
Turkey	10,500	13%	76	1.20%	30.1	11	3	51%	5.3	72.0	77.2	60
Saudi Arabia	24,911	47%	29	2.90%	25.7	22	5	50%	0.9	72.4	76.4	60

- At present, the population demographics in the Muslim World are young with a median age in the twenties.
- The old age support ratio (the number of people between ages 15 to 64 to those older than 64) is expected to drop sharply from 11 or higher in 2012 to around 5 in 2050.

Source : Government Department of Statistics, World Bank, CIA World Fact Book and Indexmundi websites

DRIVERS TOWARD GREATER PRIVATE PROVISION

According to the historian Baladhuri, the model of a state-funded pension in an Islamic territory can be traced to the time of the second Caliph Omar, where the state treasury stipulated a stipend for certain groups of people.[1] Fast-forward to the current day and this legacy remains intact, with many Islamic states heavily engaged in various guises in providing retirement benefits to their civil servants and broader citizenry. These are now sizable commitments and, as shown in Figure 1, they are rising.

As with elsewhere in the world, many Islamic nations are experiencing the twin forces of rising life expectancy and a decline in fertility rates, as outlined in Figure 2. By 2030, it is anticipated that the old age support ratio (i.e., the number of persons age 15 to 64 per person age 65 or over) will begin to drop in many Islamic countries. This will make it increasingly difficult for governments to shoulder the financial burden for retirement provision. It is inevitable that a greater share of the responsibility will transfer to the private sector, either via occupational or personal savings.

There is also a religious dimension that may drive greater private pension provision. Historically there has been considerable reliance on various financial institutions and social arrangements in Islamic societies. For instance, a large family; community care; the *bait al-māl* system (Islamic treasury whereby the government provides welfare support for the poor and elderly); and *awqāf* (endowments, based on philanthropy). But some scholars deem such pillars of provision to be at odds with the higher objectives of Shariah (*maqāsid al-Sharia*), which include an obligation on the individual to avoid being a burden on others. In line with the guiding principles of protection of life, family, and wealth, individuals should save for their old age. Acceptance of this view may add further impetus to the move to a formalized private pension provision.

Taking these influences together, it is easy to envisage an increasing appetite for pension vehicles, whether through personal, occupational, or state-managed frameworks.

We can look at existing pension fund operating models for inspiration on how new pension vehicles should be structured. However, they may not be fit for purpose. In Islam, a juristic principle states that everything is allowed as long as there is no proof that prohibits it. But various elements of the conventional fund models are considered to be *haram* (forbidden). This demands that we think about a special Islamic fund model, taking account of all relevant *fiqh* (jurisprudential) sensitivities.

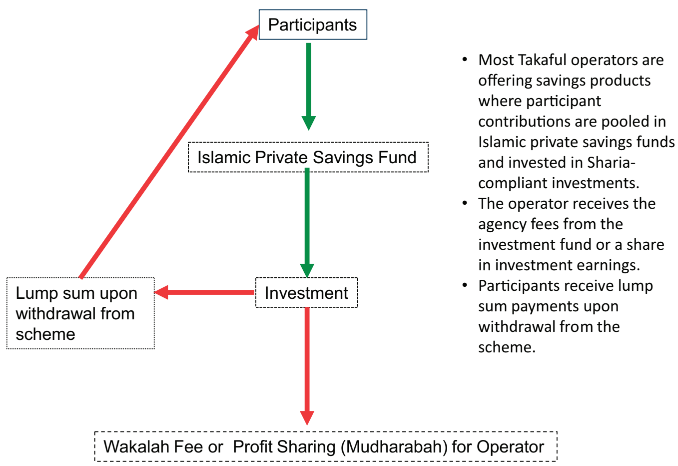
INTEREST DURING ACCUMULATION AND ANNUITIES IN DECUMULATION: THE DUAL PROBLEMS IN STRUCTURING AN ISLAMIC PLAN

The first phase in personal pension provision is the accumulation of contributions. These are pooled in investment funds until the time of retirement.

The investment must be compliant with Shariah principles. By collaboration between the financial services industry and Shariah authorities, there are now many *Takaful* (Islamic insurance) operators to help construct products that meet those principles. The pension company may take the role of a *wakeel* (agent) to manage the fund, or instead act as a *mudharib* (somebody who applies skills in partnership with a contributor of capital in a profit-sharing venture). There may be a requirement for *zakah* (a form of levy discussed further below), but broadly speaking the implementation would be fairly straightforward.

Once a fund has grown, we must then consider the decumulation phase. This is where participants begin to draw their benefit. The situation is relatively straightforward if at the time of retirement the participant wishes to receive their benefit as a lump sum This type of arrangement is illustrated in Figure 3 and is offered by many *Takaful* operators.

FIGURE 3
Structure of Private Occupational/Individual Savings Products Being Offered by Takaful Operators



However, it is generally accepted that an annuity is a better mechanism for providing a secure retirement income than annuity lump sum. It is the provision, via an *'aqd almu'awadhah* (contract of exchange), that introduces additional challenges to the Shariah-compliant pension framework. We encounter the following:

- ***Riba* (interest):** The income received under the annuity may be more than what one pays to purchase the annuity.
- ***Gharar* (uncertainty):** One does not know for how long he will live, and hence the amount he will receive is unpredictable.

- ***Maysir* (gambling):** Looked at another way, people who buy annuities cannot know how long they will live and are arguably betting against the annuity provider that they will outlive the life expectancy determined by the annuity provider

OTHER *FIQH* CONSIDERATIONS IN PENSION GOVERNANCE

Besides the issues of annuities, there are other *haram* elements within the conventional model that should be addressed to provide a Shariah-compliant platform. Primary considerations are as follows:

- **Asset ownership levy:** Depending on the plan structure and mode of funding, there may be a need for the payment of *zakah* (a form of levy usually at the rate of 2.5% per annum based on the ownership of certain types and net quantities of asset, due after possession for one lunar year). There is difference of opinion among Islamic scholars on this issue.

- **Exploitation:** There is scope for *ghaban* (the exploitation of a client based on his ignorance of what is prevailing in the market). This is considered a particular risk in defined contribution plans on account of both the layman not understanding the underlying investments and the charging of an administration fee by the fund manager.

- **Terms of contract:** A pension fund model may be construed as a guarantee or as a promise, or as elements of both. This distinction is important in Shariah terms because it can have legal consequences; adding to this, there is ambiguity over some of the case laws.

- **Availability of long-term Islamic investment instruments:** In a mature pension market, an insurance company selling an annuity product will seek to manage the interest risk from writing the annuity by investing in conventional long-term bonds. However, a *Takaful* operator does not have access to conventional bonds. Islamic bonds are available, constructed through *sukuk* (financial certificates)—but they are likely to be for significantly shorter terms than required to provide a good match for a stream of annuity payments for a relatively young individual.

- **Inheritance:** In a conventional pension fund model, if the contributor dies before retirement the funds pass to that person's estate for distribution among heirs. However, in a form of pension model where the benefit rights only accrue at the point of retirement, then at the time of preretirement death there will be no ownership. This may lead to problems in distributing the accumulated benefit to dependents.

- **Divorce**: In Islam, a contract of *nikah* (marriage) is not an economic venture or partnership between spouses as it might be in some legal systems. The actuarially determined fair value of a pension entitlement can often form a significant part of a divorce settlement in other markets. Special considerations may be required to protect all parties.

WORKABLE FRAMEWORK

We must now think about how we can customize the core model for a pension scheme for compliance with these Shariah principles. We are still at the drawing board on this.

A key component of any viable framework will be the availability of long-term financial instruments. There is a need for deeper availability of *sukuk*, especially for longer terms. A solution here may be a long-term sovereign *sukuk*. This could be based on long-term infrastructure *istithna'* (projects), e.g., toll roads or airports, where the rental income from leases would service the payments due. A possible model for this is outlined in Figure 4.

These *sukuk* could be structured in such a fashion to provide a stream of payments similar to an annuity, and play a role in the operating model outlined in

Figure 5. Participants would place money (family *tabarru'*) via an *uqūd al-Tabarru'āt* (contract of donation) to a pension pot, implemented via a legally binding *wa'ad iltizāmi* (self-imposed promise). The family *tabarru'* is meant to cover the family in case of premature death of the participant and may help alleviate some of the Shariah-compliance considerations related to inheritance. As a unilateral contract it would not attract *riba, gharar, or maysir*.

To clarify, these are simply theoretical models that have been discussed in the *Takaful* community and have not yet been implemented. Further engagement is required from industry and government stakeholders to provide the framework for such models to flourish.

CONCLUSIONS

In summary, there should be a role for greater pension provision in Islamic countries. There are special sensitivities that will need to be taken into account in structuring such provision. The non-applicability of annuities and conventional bonds along with the other special governance considerations make this a complex landscape. There is an opportunity for actuaries to help sculpt this landscape. □

ENDNOTES

[1] Zaman H. [1991], Economic Functions of an Islamic State [The Early Experience], Leicester: Islamic Foundation

FIGURE 4
Proposed tranched longevity sukuk based on istithna'-cum-ijarah model

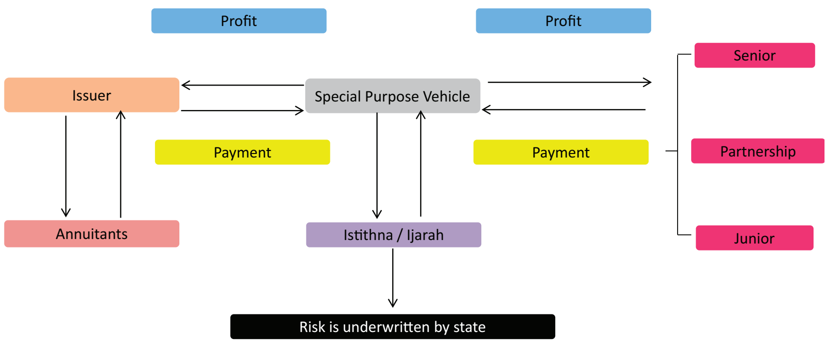


FIGURE 5
Suggested model for private occupational Islamic Pension fund