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JUNE 2018

THE MALAYSIA DEVELOPMENT EXPERIENCE SERIES

Case Study on the Employees Provident Fund of Malaysia



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Acknowledgements

The report was prepared by a team of the Finance, Competitiveness & Innovation Global Practice of the World Bank Group consisting of William Joseph Price (task team leader), Muhammed Abdul Khalid, Jose De Luna Martinez, Wei Zhang and Ashraf Arshad.

Other colleagues including Richard Record, Nadia Novik and Mohamed Rozani Mohamed Osman provided useful inputs. Joshua Foong and Kane Chong provided excellent editorial assistance.

The team received guidance and support from Ceyla Pazarbasioglu, Zoubida Allaoua, Ulrich Zachau, Mara Warwick, Irina Astrakhan, and Faris Hadad-Zervos. The team expresses its gratitude to peer reviewers in the World Bank Group i.e. Fiona Stewart, Swee Ee Ang, and Achim Daniel Schmillen for their thoughtful comments and suggestions.

We are indebted to the Employees Provident Fund (EPF) for its valuable collaboration with the World Bank Group. In particular, the team is grateful to Tan Sri Samsudin Osman (Chairman), Datuk Shahril Ridza Ridzuan (Chief Executive Officer), Dato' Mohamad Nasir Ab. Latif, Tunku Alizakri Raja Muhammad Alias, Nurini Kassim, Badrul Hisham Dahalan, Samsiah Mohd Yusop Sulaiman Mohamed Ridza, and Syazrah Arinah Abd Salam, who were exceptionally forthcoming and proactive in providing insights and information. The team would like to also thank the past Chairman and Chief Executive Officer of EPF who participated in this study and shared their inputs with us.

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Executive Summary

This paper documents the best practices and practical lessons learned from Malaysia's largest mandatory public provident fund, the Employees Provident Fund (EPF). The objective of this paper is to increase the knowledge base of efficient pension funds for developing countries, drawing from Malaysia's experiences. Findings include key critical factors that contributed to the success of the EPF, from a small pension fund set up in 1949, to become one of the largest pension fund among developing countries and the 15th largest in the world.¹ This paper summarizes the EPF's key strategies in corporate governance, investment, and operational strategies, as well as policies deployed by the EPF in managing its assets.

The lessons from the EPF come from three main factors. Firstly, the EPF has developed a strong governance structure which discourages external political meddling and encourages transparency and accountability. Secondly, the EPF's investments strategy, guided by its Strategic Asset Allocation, including diversifying to foreign markets and new asset classes, has enabled the Fund to produce enhanced returns. Thirdly, the EPF's operational effectiveness which is driven by the professionalism of their employees and their continuous improvement for members' benefit.

Nonetheless, several challenges remain in the present and in the future. The first challenge involves demographic changes as Malaysia is ageing more rapidly than other countries and even now a sizable number of workers do not have the recommended minimum savings level needed for retirement. A revamp of the current model is needed to ensure that members will be financially independent post-retirement. The second challenge is lack of coverage: only half of those in the labour force are contributing to the EPF, which leaves the other half without old-age pension coverage. A reform agenda needs to expand coverage particularly for the self-employed. The final challenges are maintaining public trust and staying relevant, especially in the age of the fourth industrial revolution and the emerging gig economy that has different needs and demands.

This case study will hopefully be of benefit to both policy makers and practitioners, particularly in the developing world. It could help play an important part in designing a successful provident fund to contribute to a comprehensive social safety net for citizens.

¹ Willis Towers Watson. 2017. The World's 300 Largest Pension Funds. Available from <https://www.willistowerswatson.com/-/media/WTW/PDF/Insights/2017/09/The-worlds-300-largest-pension-funds-year-ended-2016.pdf>

Objective

This paper aims to document the critical factors that transformed the EPF from a relatively small public retirement fund for both private sector and non-pensionable public-sector employees to become one of the largest in the world. It provides practical lessons and actionable policy measures, while providing insights for an efficient provident system for developing countries, drawing from Malaysia's experiences. Among others, the paper sheds light into the EPF's key success factors, including its investment and governance strategies, the required building blocks, and main challenges and constraints. The model presented is not the only way to provide pensions in a country. But it does show the benefits of a particular approach that should be considered by policy makers in other countries when designing or reforming a pension system.

To achieve these objectives, the study undertook a two-pronged approach:

1. Desktop review, including collecting baseline benchmark and secondary data, and
2. Conducting semi-structured interviews with past and present key senior management of the EPF (please see Appendix for the list of individuals interviewed).

This paper focuses in some detail on the best practises of the EPF, but does not provide in-depth analysis on the challenges for the EPF. Although the paper does outline future challenges for the EPF, it does not specifically articulate policy options, nor does it discuss the challenges related to the functioning of the EPF as a social protection institution or the history and lessons from the development of the Malaysian capital market. These matters will be addressed in detail in further papers.





KWSP | EPF



CHAPTER 1

Why the EPF?

Why the EPF? What can other countries learn from the EPF? The EPF is one of the largest public defined-contribution retirement funds in the world.

As of end-2016, the EPF total asset under management was RM731.1 billion (or about USD 165 billion), making it the second largest pension fund among the developing countries, the 5th largest in Asia, and 15th largest in the world.

To put things in perspective, the Malaysian economy and workforce are relatively small compared to other countries; Malaysia is ranked 66th in terms of nominal GDP per capita, and 36th and 11th in the world and in Asia respectively² in terms of working population size. Although the EPF is managing pension funds for a relatively small workforce compared to developed countries, the EPF has investments in all major markets, in particular North America, Europe and Asia, as well as investments in various asset classes such as equities, fixed income instruments, real estate & infrastructure and money market instruments.³ So, the EPF model shows the benefit of scale that can be brought to a relatively small country – and which can lead to further benefits if scale can be combined with good governance and expertise. Many countries have adopted a similar model. Some have experienced good results – for example in Kosovo which is the subject of another case study in this series. Others are yet to reap the full benefits – and this case study shows some critical steps on the journey to ensure that similar organizations can deliver enhanced value-added for their populations.

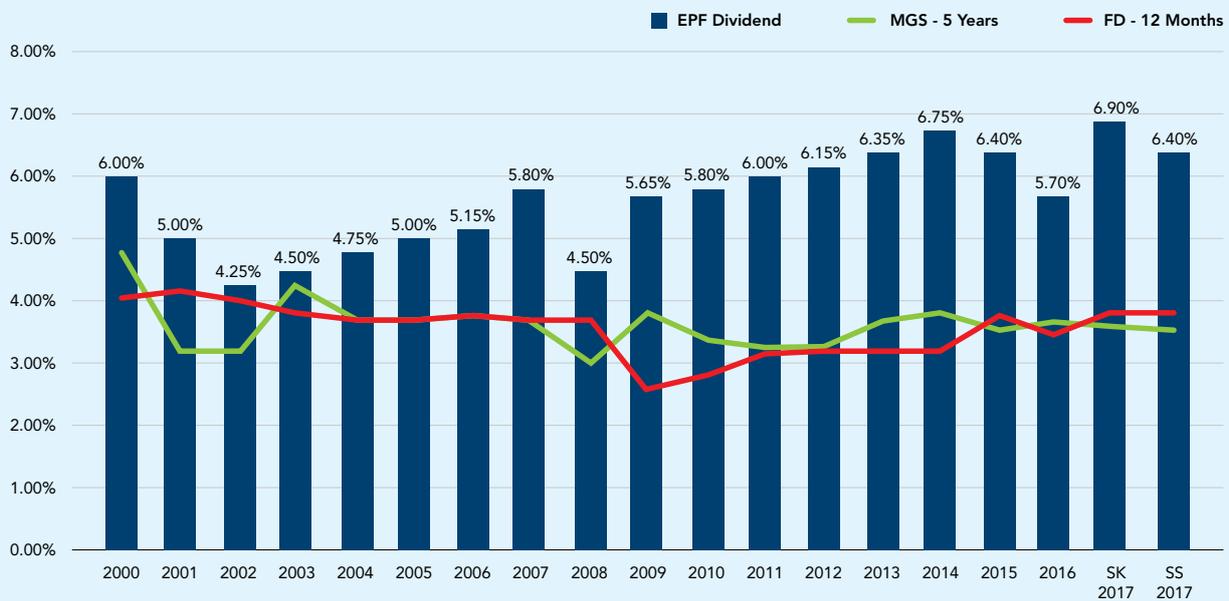
The EPF has focused on developing in-house investment expertise over the years to make large scale investments in a global portfolio in multiple asset classes. It engages external fund managers as well, and it has implemented a stringent process to evaluate the implementation strategy that delivers best net of fees returns.

The EPF has consistently produced competitive returns. The average dividend during the period 2010-2016 was 6.20% per annum in nominal terms. The Fund has consistently outperformed its real 2.00% target for 16 years running, except for the year 2008, where the real return was lower at 1.50% due to the Global Financial Crisis. To put this in perspective, it is important to compare it to some counterfactuals. Figure 1 compares investments in Malaysian Government Securities (which used to make up the bulk of the EPF portfolio in past decades) and the yield on 1-year fixed deposits (which would be one simple saving strategy for EPF members if they were not locking their savings away in a pension). The chart shows that the EPF has consistently outperformed both Government Bonds and 12-month deposits since 2002. But more importantly the chart shows that as the EPF put in place the major reforms outlined in this report – including developing its broader investment allocation including foreign assets from the early 2000's, the degree of out-performance by the EPF relative to government bonds and term-deposits increased from around 1.00% point a year on average to 2.50% - 3.00% points a year on average.

² IMF (International Monetary Fund). 2017. World Economic Outlook Database: October 2017. Washington, D.C.: IMF; World Bank. n.d. Development Data Group Database. Washington, D.C.: World Bank.

³ EPF (Employees Provident Fund). 2017. Annual Report 2016: The Financials. Kuala Lumpur: EPF, p. 145.

FIGURE 1: EPF returns relative to Malaysian Government Bonds and 1-year fixed deposits



Another insight into relative performance is to compare EPF returns to other pension fund providers.

In Malaysia, the Private Retirement Schemes (PRS) were introduced in 2013 to provide for individual retirement accounts. As such there is only a run of data from 2013 to 2018. Ideally, return comparisons would be made over longer time periods. Over that time period the EPF average annual dividend was 6.40% and its average return on investment was 7.20% in nominal terms. PRS portfolios can be cautious, moderate or growth orientated. The respective average returns between 2013 and 2018 were 3.51% for the cautious funds, 4.07% for the moderate funds and 4.87% for the growth funds.⁴ The EPF asset allocation is closest to the moderate or the growth funds – but the results show that its returns have been superior over a comparable time period than all the major PRS fund types – with the annual outperformance on average investment returns ranging from 3.70% for cautious funds, 3.10% for the moderate and 2.30% for the growth fund.⁵

So, what did the EPF – a pension fund from a developing economy – do right to improve its performance as it became one of the biggest public provident pension funds in the world? Before we explore the key success factors, let us review the history and background of the EPF.

4 In all cases the average figures are simple averages for the respective funds and the EPF returns.

5 EPF members can also choose the ‘EPF-MIS’ option, or the Member Investment Scheme which allows access through the EPF to unit trusts run by private fund managers. There are between 200 – 400 options. It is difficult to get clear comparisons between the performance of the different funds and the EPF over time. The EPF-MIS plans can charge fees of up to 3.00% of assets under management a year – though many charge in the 1.00% to 2.00% range. This gives the EPF an inbuilt 0.70%-1.70% real return head start each year given the overall fee level in the EPF of just under 0.30% as a share of assets under management. But part of the point of the EPF-MIS choice is as much to allow members to choose different asset allocations that might fit their needs given that the EPF runs a single investment strategy. The EPF-MIS plans also do not have the EPF’s 2.50% nominal return guarantee.

Background

The EPF was set up by the Federal Labour Department in 1949, eight years before Malaysia gained independence from the British. In 1951, this entity became a statutory body, set up under the Employees Provident Fund Ordinance in 1951. On 22nd July 1982, the EPF Ordinance 1951 became the EPF Act 1951 (which was later replaced by the Employees Provident Fund Act, 1991) with the mandate of “managing a defined contribution retirement scheme which is compulsory for private sector and non-pensionable public-sector employees. It also covers the self-employed, informal sector and foreign workers, but on a voluntary basis⁶.” The contribution is tax deductible up to RM6,000 annually, and the dividends earned from the fund are tax-free.

Obligated by law

Every employee and their employer are required to make prescribed monthly contributions to the EPF. The current contribution rate is as below:

- a. 24.00% (11.00% by employees and 13.00% by employers) for employees who earn less than RM5,000 per month
- b. 23.00% (11.00% by employees, 12.00% by employers) for employees earning more than RM5,000 per month
- c. For employees aged above 60, the contribution is set at half the regular rate

As shown in Table 1, the contribution rate started at 10.00% in 1952, split evenly between employee and employer. The contribution rate gradually increased to about one fourth of current wages, which is the fifth highest in the world.⁷

⁶ EPF. 2017. Social Protection Insight 2017. Kuala Lumpur: EPF. p. 2. Available from <http://src.um.edu.my/wp-content/uploads/2017/12/latestfinalnewsletterissc3august-170615043428.pdf>.

⁷ EPF. 2016a. Annual Report 2015. Kuala Lumpur: EPF. p.66.

TABLE 1: Summary of Employees Provident Fund contribution rates in Malaysia (percentage), 1952-2018

YEAR	EMPLOYEE	EMPLOYER	TOTAL
1952 - June 1975	5	5	10
July 1975 - November 1980	6	7	13
December 1980 - December 1992	9	11	20
January 1993 - December 1995	10	12	22
January 1996 - March 2001	11	12	23
April 2001 - March 2002	9	12	21
April 2002 - May 2003	11	12	23
June 2003 - May 2004	9	12	21
June 2004 - May 2005	11	12	23
June 2005 - December 2008	11	12	23
January 2009 - December 2010	8	12	20
January 2011 - December 2011	11	12	23
January 2012 - February 2016			
Income RM5,000 and less	11	13	24
Income more than RM5,000	11	12	23
March 2016 - December 2017			
Income RM5,000 and less	8*	13	21*- 24
Income more than RM5,000	8*	12	20*- 23
January 2018 - present			
Income RM5,000 and less	11	13	24
Income more than RM5,000	11	12	23

Source: EPF (various years).

* Reduction of the contribution rate is available upon request of employee. By virtue of P.U(A) 21, the statutory rate for employee's contribution is 8.00%. Section 43(3) and 43(4) of the EPF Act 1991 provides an option for the employer or employee to increase their contribution rate by giving notice to EPF. If the employee elects to pay monthly contributions at a rate which exceeds 8.00%, he shall give a notice of such election through Form KWSP 17A (Ah) to the Board. The rate elected by the employee is applicable as a statutory rate until, the employee, at any time, revoke his election by submitting Form KWSP 18A (Ah) by virtue of section 43(5) and 43(6).

During economic crises, in order to boost private consumption or spending, the EPF would allow a reduction in the employees' mandatory contribution rate to the fund. This was the case in 2001 – after the Asian financial crisis in 1997/98 – when the contribution rate was reduced from 11.00% to 9.00%, as well as during the 2008–2009 global economic and financial crises, when it was reduced from 11.00% to 8.00%. In 2016, the EPF adopted the same strategy, albeit with minor modifications. The employees have no option to reduce their contribution rate, the statutory rate was 8.00% for the period of March 2016 until December 2017, but if the employee elects to pay monthly contributions more than 8.00%, the election can be made to EPF. Nearly 60.00% of the members took up the option to revert to the earlier 11.00% statutory rate.

Each employee, upon starting work in the formal sector, must register with the EPF, and the employers are obligated by law to ensure contributions are made. Failure to do so is punishable by law, and in some cases, the employers have been taken to court and their management barred from leaving the country. The EPF invokes Section 39(1)(a) of the EPF Act 1991 to bar errant employers from leaving the country, and it is not unusual for the EPF to release press statements⁸ from time to time to declare the number and names of company directors submitted to the Immigration Department to prevent them from leaving the country, until they settle their EPF arrears. These statements are made in tandem with “naming-and-shaming” employers with the highest fines who have failed to remit their employees' EPF contributions.

Types of EPF accounts

Once registered, the member will have his/her own EPF savings account, of which the savings will be split into two accounts: 70.00% of the monthly contribution goes to Account 1, and 30.00% goes to Account 2. Once a member reaches the retirement age of 55, withdrawal from his account (Account 1 and Account 2 will be merged) is allowed. It is not an automatic withdrawal; members need to apply to take out their savings and decide whether to withdraw the lump-sum or on a staggered and as-needed basis, i.e. members are allowed to continue to keep their retirement savings with the EPF past 55 years old and enjoy the annual dividend on their balance.

Members are allowed to withdraw fully from Account 2 upon reaching Age 50. Pre-retirement withdrawals from Account 2 can also be made for the purpose of pre-retirement such as: for housing, i.e. to purchase a house, to reduce or redeem a house loan, to build a house; for education, i.e. to finance their or their children's education; and for health, i.e. to pay for a specific health-related matters. Account 2 can also be utilised by eligible members to perform the Hajj (pilgrimage).

In addition, qualified members are allowed to withdraw from Account 1 to invest in approved unit trust schemes. Finally, should a member cease to be a Malaysian citizen, he/she can choose to make a full withdrawal from the EPF.

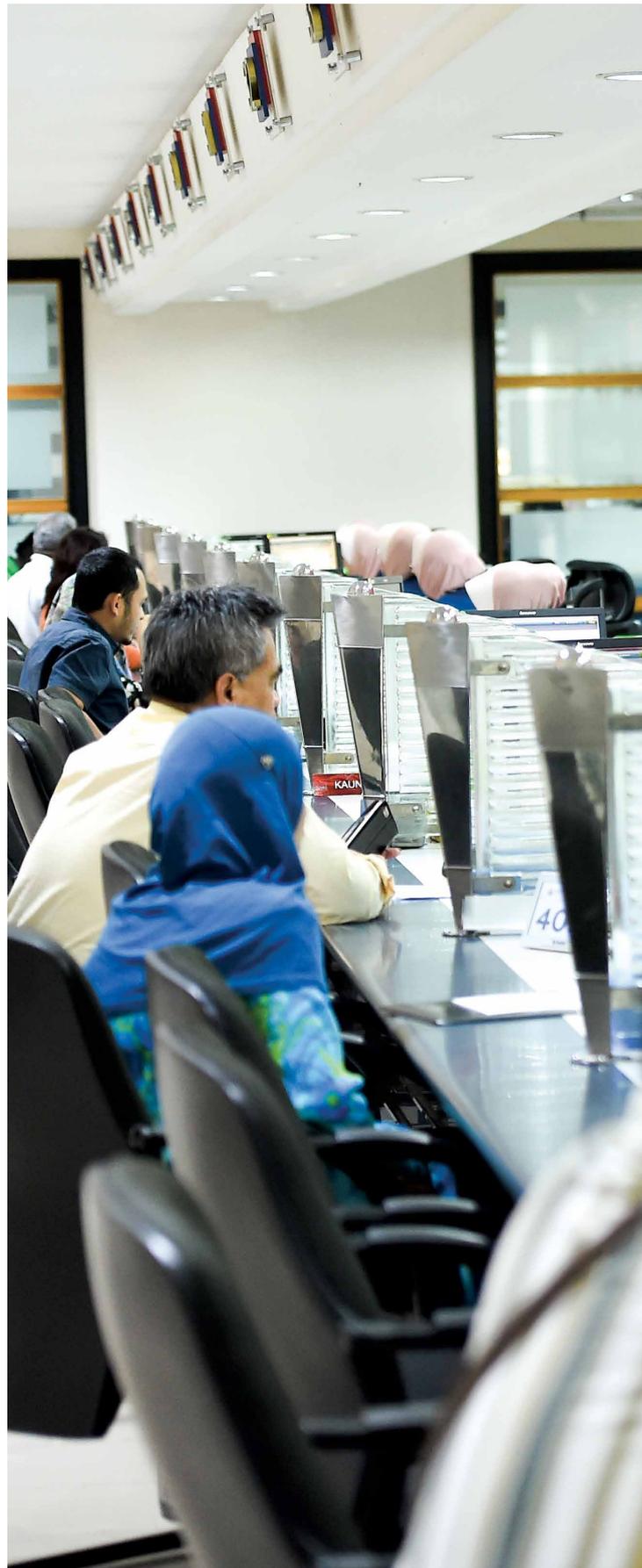
⁸ Utusan. 2014. “249 pengarah syarikat dilarang ke luar negara – KWSP”, 17 September 2014. Available from http://ww1.utusan.com.my/utusan/Dalam_Negeri/20140917/dn_29/249-pengarah-syarikat-dilarang-ke-luar-negara---KWSP on 13 March 2018; EPF. 2014. ‘249 Company Directors Prevented from Leaving the Country.’ Available from <http://www.kwsp.gov.my/portal/en/news-listing..>

⁹ EPF. 2017b. Annual Report 2016. Kuala Lumpur: EPF.

As of end-2016, there were approximately 14.8 million employees with an EPF account, contributing nearly RM60 billion to the fund in that year alone, equivalent to RM5 billion per month.⁹ However, the total number of active members was only 6.88 million, and the total number of active employers was 546,000. Active members are defined as having contributed at least once a year. Thus the remainder are those that no longer contribute, which also includes those who are past retirement age, yet still maintain their EPF accounts. As at 31 December 2017, the number of formal sector firms that contribute to the EPF is 494,945 employers, while the number of informal sector contributors is 90,599.

Not all private sector workers contribute to the fund (government employees have their own public pension scheme), although non-pensionable public-sector employees must register with the EPF. Only 46.90% of the entire labour force was an active EPF member at the end of 2016, which is in fact lower than in the year 2005 (50.50%). Nearly one in four active members in 2016 was between the ages of 16 to 24, while 46 per cent was between the ages of 25 and 40. About 10.00% of active members were nearing retirement (51–60 years old).

The EPF is a statutory body, but the structure and remunerations are different from government entities in Malaysia. Employees of the EPF do not participate in the civil servant pension scheme. Instead, the corporate structure mirrors those in the private sector. To ensure that the mandate is achieved while reflecting on the real nature of the business, the EPF board members are made up of representatives from employees, employers and the Government, as well as professionals from business and financial related fields. Members of the Board and the Investment Panel, including the CEO, are appointed by the Minister of Finance.







CHAPTER 2

Practical Lessons and Best Practices

From our discussions and interviews with the EPF's top management,¹⁰ we identified several strategies and structural reforms deployed by the EPF that were critical in their success, namely:

- a. strong governance structure;
- b. sound investment policies and strategies; and
- c. operational effectiveness, focusing on and investing in its employees and customers.

¹⁰ Interviews were conducted in November 2017.

Clear governance structure

The most vital ingredient which ensures the fund runs well is that professionals make up the governance structure, and is guided by two key factors: independence and transparency.¹¹ The governance structure was reformed in 2001,¹² when then Finance Minister Daim Zainuddin separated the positions of the executive Chairman of the EPF to two separate posts, a Chairman and a CEO. Both are endowed with different powers to ensure a balance of power, as reflected in the EPF Act 2001 and to ensure that no one person can make the decision. This is important in avoiding political meddling and allows the Fund to act independently in the best interest of its members.

The EPF is governed by a Board, and its members are made up of different sets of stakeholders. Board members must include representatives from employees, employers, industry professionals and the government, as stated in the Act. By virtue of Section 4(1) of the EPF Act 1991, "... the Board shall consist of: a Chairman, a Deputy Chairman to be appointed from the persons who are holding office of emolument under the Government of Malaysia or of a State; the chief executive officer, who shall be an ex-officio member; and not more than eighteen other members of whom five shall be persons who are holding office of emolument under the Government of Malaysia or of a State, five shall be employers contributing to the Fund and not being persons holding office of emolument under the Government of Malaysia or of a State or employed by any statutory or local authority; five shall be employees contributing to the Fund; and three shall be persons who shall have experience in finance, business or other relevant experience".¹³

In other words, the Board's composition is based on the principle of tripartite representation, whereby there are representation from the EPF's primary stakeholder groups which are the employees, employers and government. Members of the Board also serve as representatives from industry, business and economy. The distinct groupings are to ensure that the EPF is fully independent in the running of the Fund, with minimal interference from external parties. Board members must also have the requisite qualifications and technical skills, and a due diligence process is strictly adhered to before appointing any Board member. All candidate must undergo financial screening by the Central Bank.

Discussion during Board meetings have been described as "democratic"¹⁴ and "consensus driven"¹⁵ (i.e. "we don't bang tables"¹⁶), and everyone is clear that Board decisions on every matter is guided by one overriding principle which is "... doing what is best for the members".¹⁷

11 Interview with Tan Sri Abdul Halim Ali. 20 Nov 2017.

12 The post of Chief Executive Officer is introduced by virtue of the amendment of Section 30(1) of the EPF Act 1991 which comes into effect from 31 October 1996. It provides that the Minister shall appoint a fit and proper person, on such terms and conditions as he may determine, as chief executive officer, who may be designated by any name as determined by the Board.

13 EPF Act 1991, 1 June 1991; P.U. (B) 264/91

14 Interview with EPF top management. 20 November 2017.

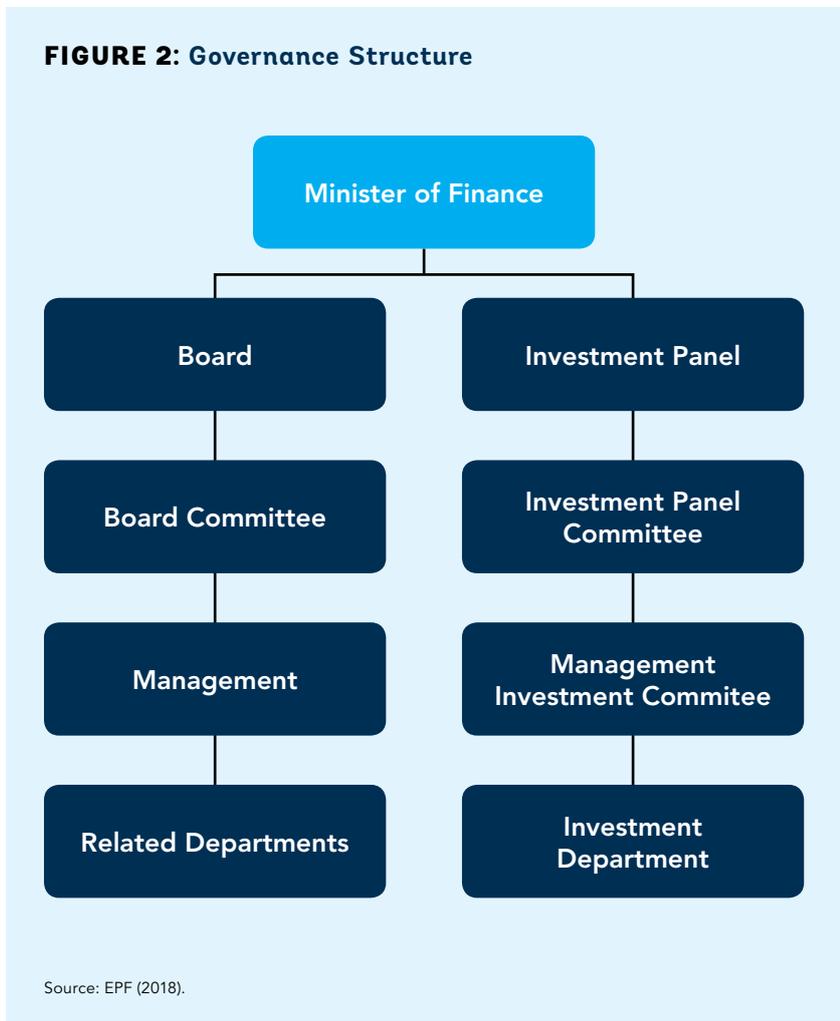
15 Ibid.

16 Ibid.

17 Ibid.

While the Board consists of members representing the government, employers and employees, the Investment Panel, which is responsible for matters pertaining to the investments of the Fund, is dominated by professionals from the private sector. Apart from the CEO and Chairman, there is one representative each from the Central Bank, the Ministry of Finance, and three private sector professionals in the panel. The appointment to the Board and Investment Panel is decided by the Minister. Section 18(1) of the EPF Act 1991 provides that "... the Investment Panel is responsible for matters pertaining to the investments of the Fund and shall consist of the Chairman, or any other person to be appointed by the Minister of Finance, who shall be the Chairman of the Investment Panel; the Deputy Chairman who shall be a representative of the Ministry of Finance; the Governor of Bank Negara Malaysia or his or her representative; the Chief Executive Officer, who shall be an ex-officio member; and three other persons who shall have experience in finance, business or other relevant experience, to be appointed by the Minister of Finance".¹⁸

The governance structure is shown in Figure 2 below.



The roles are clearly defined, whereby "the Board assumes a number of specific responsibilities such as overseeing the implementation of policies related to the operations of the EPF, identifying key risks and taking appropriate steps to manage these, as well as reviewing the adequacy and integrity of the internal control systems", while the Investment Panel provides strategic directions on investment related issues, including "determining and approving investment activities in line with existing guidelines, policies on risk control and asset allocation".¹⁹ The annual dividend for the fund is proposed by the Investment Panel and sent to the Board for approval.

¹⁸ EPF Act 1991.
¹⁹ EPF (2016a).

Robust decision making

This way, the Fund splits the decision-making process into two separate entities, the Board and Investment Panel. This reflects a "... strong governance structure – the Board and the Investment Panel consist of different individuals, and each do not interfere with each other except that the Chairman and the CEO sit on both entities".²⁰

Unlike other government-linked investment companies, there are no politicians, current or retired, appointed to the Board. Political interference is rarely entertained and any meddling is handled professionally. If there are proposals submitted by politicians, which is a rare incidence, it will be sent to "the team"²¹ for evaluation, meaning all proposals must go through the same stringent governance and due diligence process.²² According to the former chairman Abdul Halim Ali, this is one of the key success factors of the EPF, and a lesson for other countries when dealing with public funds, or public interest. This approach usually works and instances are rare when the political masters are unhappy with decisions made as the EPF's decision making process is known to be robust with decisions made by committee in consensus, and is not a one-person decision. Many of the provisions in the 1991 Act are no longer binding in practice – for example the requirement to have 50.00% in Malaysian Government Securities contrasts with the actual allocation of 25.00%. In the future it would be sensible to remove the increasingly theoretical options for direction on investments to embed the current freedoms that operate in practice in law.

Structure and governance is very prominent in its investment. The Fund's position and performance are monitored closely and reported to the Management Investment Committee and the Investment Panel on a monthly basis, and to the Board on a quarterly basis. Each deal is scrutinized by the Management Investment Committee and the Investment Panel. The former meets weekly, while the latter meets every other week to discuss investment issues and to ensure close monitoring of the EPF's investments.

Every investment decision must go through the Investment Panel, without exception. The investment decision process is bottom-up. Each investment proposed by the working group after a thorough due diligence is scrutinized by the Management Investment Committee before it is tabled to the Investment Panel for approval. The proposal must meet the risk limits proposed by the Management Risk Committee (MRC) and approved by the Investment Panel Risk Committee (IPRC). Any revision on the risk limit will have to be approved by the MRC and IPRC. Additionally, with the introduction of Simpanan Shariah, all EPF's shariah-compliant investments and processes have to be endorsed by the Shariah Advisory Committee for shariah compliance status. On top of that, the conversion of Ringgit Malaysia to foreign currencies for the execution of overseas investment must abide by the rules and regulations set by the Central Bank. Almost all "investment ideas start at the unit level ... bottom-up ... and even if the proposal was originally submitted at the Board or management level, the (proposal) papers would be submitted to the line departments, no exceptions".²³ The Board has never intervened on investment decisions; they "sometimes gave views on what not to invest, but never advise on what to invest".²⁴ The risk management framework of the EPF has had to undergo significant enhancement in parallel with the expansion of the asset allocation into new asset classes and new countries.

²⁰ Interview with Tan Sri Samsudin Osman. 23 Nov 2017.

²¹ Ibid.

²² Interview with Tan Sri Abdul Halim Ali. 22 Nov 2017.

²³ Interview with Tan Sri Samsudin Osman. 23 Nov 2017.

²⁴ Interview with EPF top management. 20 Nov 2017.

Once the decision is made, the investment can be executed immediately if the asset type is part of the allowable investment as stated in the EPF Act Section 26. Otherwise, an approval from the Minister of Finance is required. The EPF Act 1991 Section 26(2) stipulates that investment in companies through joint ventures and direct investments, privatisation and investments in funds and fund of funds require approval from the Minister of Finance. Ultimately, as in other countries that allow well-run pension funds to follow a 'prudent person' investment approach without investment limits set by the government given the scale, expertise and governance of the EPF.

Post-execution of the investment, monitoring and reviews are done regularly. For investment in listed and readily tradable securities, each investment must be based on the approved universe (countries, issuer and sector) that is reviewed regularly. The review process includes attending annual general meetings, analyst briefings, performance monitoring and site visits.

Voluntary disclosure

Apart from its independence, the EPF also maintains transparency by voluntarily disclosing its investment position and performance on a quarterly basis to the public, though it is only required to do so on an annual basis. All the information can be downloaded from its website, and is widely reported in the newspapers and social media. The Fund's investments are audited internally every quarter. The Fund also undergoes an annual external audit by the Auditor General. In fact, auditors from the Auditor General office have a permanent office at the EPF headquarters. The Fund's annual report, which includes the audited financial statement, is required to be tabled to the parliament before it is released to the public.

To promote good corporate governance in Malaysia, the EPF became a signatory to the Malaysian Code for Institutional Investors in early 2017, which aims to strengthen the accountability of institutional investors to their own members and investors. The EPF was also actively involved in developing the Code, which aims to promote effective stewardship by institutional investors such as disclosure of stewardship policy, monitoring and engagement with investee companies, as well as managing conflicts of interest. The Code encourages institutional investors to practice corporate disclosure and transparency, which in turn would lead to sustainable long-term value creation to shareholders. Engagement with regulators are also done regularly to ensure enhancement on regulations are aligned to the EPF's needs to conduct its fiduciary duties.

The EPF is an active participant of the Minority Shareholders Watchdog Group (MSWG) to promote sound corporate governance. The Group continuously engages with investee companies to ensure that the members' interest is protected and that investments are managed in a responsible and sustainable manner. Over the years the MSWG has evolved into an independent research organization on corporate governance matters, and it provides a platform and a collective voice to both retail and institutional minority shareholders. The MSWG also advises on voting at general meetings of public listed companies. In fact, the EPF was one of the leading proponents for its establishment in the year 2000 given that the Fund has investment in various companies listed in the domestic stock exchange. Incidentally, the first MSWG chairman (2001-2013) was former EPF chairman Abdul Halim Ali (2001-2007).

Investment policies and strategies

The EPF's investments are steered by their Strategic Asset Allocation (SAA) strategy to ensure that the fund optimizes its returns within its risk tolerance level. The investment policy design and management choices are guided by its mandate as stated in the EPF Act 1991, which is "to preserve and enhance the savings of its members". This is in line with the fund's vision of "helping members achieve better future", and its mission to "safeguard member's savings and deliver excellent service".²⁵ In fact, every decision concerning all investments are guided by one overriding aim, which is that everything is done based on "... what is best for the EPF members". It was very noticeable that this phrase was repeatedly used during interviews with the EPF, from the Fund's first CEO or Chairman, to the existing top management. As their aim is to preserve capital, the investment stance is "prudence" and "we don't do adventure".²⁶

The EPF's investments are managed by the Investment Division, which has two long-term objectives:

1. to preserve and enhance the capital value of members' contributions, and
2. to maintain stable and consistent returns over the long term within tolerable risk limits.

Two explicit targets are set to achieve the above objectives: first, a 2.50% nominal dividend minimum annually (only for those who opted for conventional savings), and second, a 2.00% real dividend on a rolling 3-year basis. The dividend rate is declared based on the realized income recorded during the year, which depends on the actual market performance for the same year. The EPF does not have any dividend reserve to smoothen the returns. For this reason, it is crucial for the EPF to invest in accordance with the Strategic Asset Allocation which is designed to minimize the probability of not meeting the EPF's strategic targets as stated above.

The EPF has done well in achieving these objectives and meeting the targets.

Firstly, the average nominal dividend since inception to 2016 is 5.95%, which is well above the required minimum nominal return of 2.50% as stipulated in the EPF Act. The guaranteed nominal return of 2.50% is not very common although Singapore, Switzerland and Sri Lanka have almost similar guaranteed returns. For instance, Singapore's Central Provident Fund (CPF) guarantees a minimum of 2.50% (nominal) for its Ordinary Account (OA) by legislation.²⁷ The OA is used for housing, CPF insurance, investment and education until the account holder turns 55, in which savings in OA is placed into the Retirement Account (RA). However, the CPF requires a minimum sum of money to be retained in addition to a compulsory annuity scheme. Switzerland used to have a minimum guarantee of 4.00% (nominal) for its second-pillar provident funds. However, since 2000, the rate has been lowered gradually to 1.00% as of 2016.²⁸ Other countries that require absolute guaranteed returns according to legislation are often lower than Malaysia's 2.50% and are not public provident funds.²⁹

Secondly, the Fund has consistently outperformed its real dividend target (inflation adjusted) over rolling three-year period of at least 2.00% for 16 years running, except for the year 2008, where the real dividend was lower at 1.50% due to the Global Financial Crisis. The ability to maintain positive real

²⁵ EPF (2017b).

²⁶ Interview with Tan Sri Samsudin Osman. 23 Nov 2017.

²⁷ CPF (Central Provident Fund Board). n.d. 'Interest Rates'. Singapore: CPF. Available from <https://www.cpf.gov.sg/Members/AboutUs/about-us-info/cpf-interest-rates>.

²⁸ IPE (Investment & Pensions Europe). 2016. 'Minimum interest rate on Swiss second-pillar pensions cut to 1.00%.' 26 October 2016. Available from <https://www.ipe.com/countries/switzerland/minimum-interest-rate-on-swiss-second-pillar-pensions-cut-to-1/10015824.article>

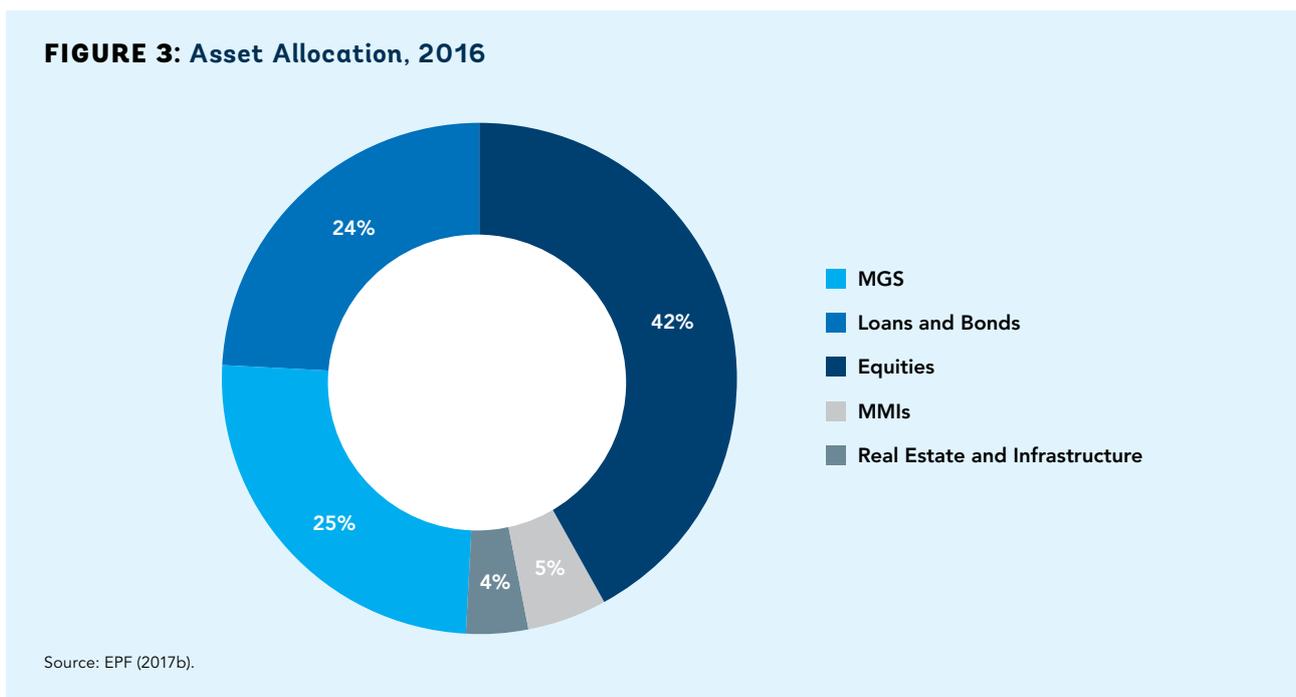
²⁹ OECD (Organization for Economic Cooperation and Development). 2011. The Role of Guarantees in Defined Contribution Pensions. Paris: OECD. Available from http://www.oecd-ilibrary.org/finance-and-investment/the-role-of-guarantees-in-defined-contribution-pensions_5kg52k5b0v9s-en.

dividend is due to the higher EPF gross income, mainly attributed to the diversification into various asset classes.³⁰ This is considered a very positive return, given that the EPF declares its dividend based on the actual realized income during the year. As mentioned in the preceding paragraph, the fund does not have any dividend reserve to smoothen its dividend payments. Through its diversification program as guided by the strategic asset allocation, the fund is able to weather economic recession as exemplified by the dividend rate in 2008. By having a long-term view of the markets, the EPF is able to increase its investment during market downturn and hold through the cycle for long term gains. The lowest ever dividend pay-out recorded was during the first few years after it was set up, when it paid a 2.50% nominal dividend rate from 1952 to 1959, which was also the minimum guaranteed dividend that EPF had to distribute each year. The highest rate of average nominal return recorded was 8.50% during the period of 1983 to 1987. The lowest ever pay-out since the 1960s was in 2002, when the nominal dividend rate was 4.25%. As highlighted above, the outperformance in returns relative to bonds and fixed deposits have increased significantly comparing the early-2000s to the last 10 years. Moreover, the EPFs investment returns have outperformed the average of all forms of Private Retirement Scheme providers by a significant margin.

So how was this improved performance created? The key goes back to the Strategic Asset Allocation (SAA) strategy, where the EPF diversifies its investments in three different ways: by asset classes, by geographical location, and by taking active risk through the appointed external fund managers.

Investment by asset classes

The EPF invests in a diverse set of asset classes; namely in equities (listed and non-listed), fixed income (government and corporate bonds), money market instruments, and real estate and infrastructure. The SAA at end 2016 is shown in Figure 3 below.



³⁰ EPF (2017b).

Almost half of the investment is in fixed income assets – Malaysia Government Securities (MGS) and loans and corporate bonds – as governed by the EPF Act 1991, while investment in equity makes up about 42.00% of the portfolio. This “rule” partly explains the booming domestic capital market in Malaysia, and at the same time ensures no sizeable outflow of capital overseas. Many of the infrastructure projects in Malaysia is funded locally, as the EPF plays a major role in some of these critical catalytic investments.

Investments in MGS and corporate bonds are governed by the EPF’s mandate of capital preservation,³¹ allowing the fund to meet its 2.50% guaranteed returns to the members. Initially, 70.00% of the investments must be allocated to fixed income. However, starting from financial year 1997, the Minister of Finance has agreed to exempt the EPF from needing to adhere to the investment requirement in government securities of not less than 70.00% from the total cumulative investments as stated in the EPF Act 1991. The EPF’s SAA allocates 51.00% of the total investment asset to fixed income investment.

The amendments in 1991 had two bigger purposes: firstly, to expand the scope and type of investment and secondly, to enable the EPF to play a more effective role as an institutional investor to create more depth in the capital market. The EPF’s investment power was expanded in terms of these three aspects:

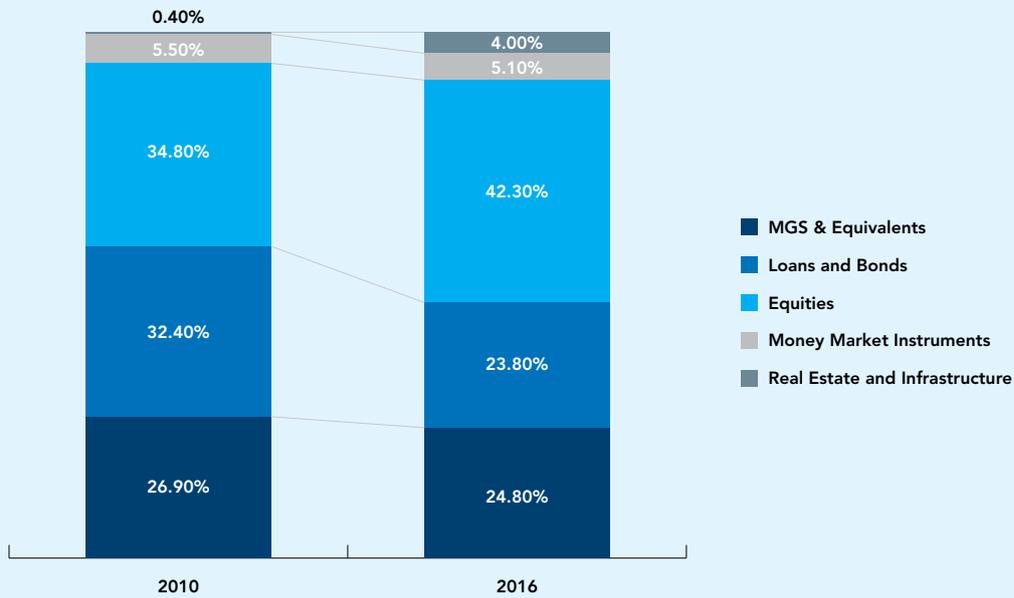
1. the new provision sets a minimum limit for the EPF’s total investment fund to be invested or reinvested during any one year in securities issued by the Government of Malaysia to 50.00% only as compared to the previous limit of 70.00%,
2. as an effort to diversify its investment, power has been given to the EPF to invest in land matters, and
3. to give power to the EPF to invest in specific types of investments, such as privatization projects, joint venture projects, securities or bonds issuance, new financial market instruments and other investments that will provide a positive and reasonable return. These amendments directly contributed to the development of capital market in Malaysia, and in particular, allowing big (infrastructure) projects to be undertaken, and to be financed domestically.

It is worth noting that the EPF played an important role in developing the domestic capital market precisely because the existing complementary institutions (e.g. the Central Bank, Securities Commission, etc.) and infrastructures (e.g. bond pricing agency, stock market etc) are already in place, and are working well. For instance, the ability of the EPF to diversify their investments in domestic corporate bond market was partially facilitated due to a well-functioning government bond market that didn’t crowd out other private investments, as well as the existing availability of domestic instruments. The financial and capital market regulators also have guidelines on new asset classes, which provide stability to the markets and market participants.

The SAA is reviewed every three years and thus, the actual composition of these asset classes has changed slightly in the past six years, as shown in Figure 4. The investment in fixed income has decreased from nearly 60.00% in 2010 to about half in 2017, while the shares of investment in equities and real estate and infrastructures have increased, from 34.80% and 0.40% to 42.30% and 4.00% respectively during the same period.

³¹ Starting from financial year 1997, the Minister of Finance has agreed to exempt the EPF from fulfilling the investment requirement in government securities of not less than 70.00% from the total cumulative investments as stated in the EPF Act 1991.

FIGURE 4: Share of Asset Classes, 2010-2016



Source: EPF (2017b).

The rebalancing of these assets has produced better returns. The decision on the composition of the assets are made based on recommendations from the internal research and the investment strategic team and approved by the investment panel. The return on investments for equities have been consistently above 10.00% for each year since 2010, making it the biggest contributor to the overall returns. This is followed by the corporate bonds which recorded second-highest returns, although since 2013, the return from investments in real estate and infrastructures have been relatively higher compared to all asset classes, except equities (Table 2).

TABLE 2: ROI and Investment Income by Asset Class, 2010-2016

Year	Asset Class	ROI	Investment Asset, RM Billion	Gross Investment Income, RM Million
2010	MGS & Equivalents	4.63%	118.50	5,588.00
2010	Loans & Bonds	5.31%	142.64	6,717.00
2010	Equities	10.58%	153.52	10,878.00
2010	Money Market Instruments	3.36%	24.01	705.00
2010	Real Estate & Infrastructure	3.95%	1.85	175.00
2010	TOTAL	6.41%	440.52	24,063.00
2011	MGS & Equivalents	4.66%	132.00	5,958.00
2011	Loans & Bonds	5.28%	152.80	7,244.00
2011	Equities	10.76%	162.09	13,074.00
2011	Money Market Instruments	3.46%	12.34	649.00
2011	Real Estate & Infrastructure	3.77%	9.81	310.00
2011	TOTAL	6.58%	469.04	27,235.00
2012	MGS & Equivalents	4.76%	140.64	6,262.00
2012	Loans & Bonds	6.24%	150.23	9,680.00
2012	Equities	10.06%	204.20	13,913.00
2012	Money Market Instruments	3.47%	18.94	575.00
2012	Real Estate & Infrastructure	5.01%	12.75	596.00
2012	TOTAL	6.87%	526.75	31,026.00
2013	MGS & Equivalents	4.28%	156.05	6,189.00
2013	Loans & Bonds	5.08%	154.76	7,527.00
2013	Equities	11.31%	251.60	19,517.00
2013	Money Market Instruments	2.97%	13.08	628.00
2013	Real Estate & Infrastructure	9.97%	14.39	1,139.00
2013	TOTAL	6.97%	589.88	35,000.00
2014	MGS & Equivalents	4.28%	164.16	6,587.31
2014	Loans & Bonds	5.13%	159.90	7,565.76
2014	Equities	11.29%	269.63	22,910.86
2014	Money Market Instruments	3.04%	23.67	619.65
2014	Real Estate & Infrastructure	8.92%	19.18	1,392.90
2014	TOTAL	7.25%	636.54	39,076.48
2015	MGS & Equivalents	4.24%	178.11	7,180.46
2015	Loans & Bonds	6.00%	171.70	8,479.28
2015	Equities	10.89%	299.76	26,013.56
2015	Money Market Instruments	4.43%	12.94	858.18
2015	Real Estate & Infrastructure	9.60%	22.01	1,702.55
2015	TOTAL	7.48%	684.52	44,234.03
2016	MGS & Equivalents	4.40%	181.30	7,722.99
2016	Loans & Bonds	5.43%	173.85	8,511.02
2016	Equities	10.35%	309.48	26,854.49
2016	Money Market Instruments	3.58%	37.02	982.28
2016	Real Estate & Infrastructure	8.22%	29.46	2,486.44
2016	TOTAL	7.12%	731.11	46,557.22

Source: EPF (various years).

Investment in overseas markets

Apart from diversification in terms of asset classes, the EPF also diversifies its investments in different markets. The decision to invest in overseas markets is relatively recent: it began just over a decade ago, more than fifty years after the EPF was established. In 2006, the share of foreign investment to total investment was only 1.00%, but it has reached 30.00% by the end of 2017. The SAA effective 2017-2019 allocates 32.00% to foreign investment, and the composition of the asset allocations is as follows: 71.00% in listed equity, 13.00% in fixed income, and 16.00% in alternative investment which comprised of real estates, infrastructure, natural resources and private equity.³²

Why did the EPF decide to invest in overseas markets, especially when investing in domestic markets has been producing returns above the mandated targets for the past half a century?

There are two key reasons, both pull and push factors:

1. EPF assets have been growing at 10.00-11.00% annually which is much faster than the growth of the domestic market, currently at 4.00%-5.00%. The Malaysian market is simply too small; in fact, the size of the fund is about 60.00% of Malaysia's GDP. The EPF's chief investment officer sums it well, "... we ran out of places to invest here".³³
2. The overseas market, such as those in developed countries, provides greater opportunities to invest in high quality matured investments that also give greater liquidity for the EPF to effectively execute its investment strategies.

While investments in overseas markets are relatively recent, the push for the need to invest in foreign assets began much earlier, especially in the late 90s. Investment in overseas markets initially began in 1996 with a very small investment in private equity funds. According to the former Chairman Abdul Halim Ali (2003-2006³⁴), although the EPF requested approval from the government to invest overseas back then, the request was turned down as the government wanted the EPF to invest domestically, in particular after the withdrawal of foreign players in the stock market during the late 90s due to the Asian Financial Crisis. The decision was later revisited when the economy recovered, and the fund started to grow at a faster pace than the growth of the economy. There was also demand from the depositors for higher returns, similar to the pre-crisis dividend rates.

Another push came from the change of guard in the EPF and the Ministry of Finance, when former banker, Aglan Zainol, was brought in as CEO in 2003, and Nor Mohamed, a former assistant governor at Malaysia's Central Bank, was appointed as the Minister of Finance in the same year. The Minister was very supportive of the asset diversification strategy, and he gave approval for the EPF's investment overseas (approval from the Minister of Finance is required for overseas investment). This emphasises the importance of personal leadership in creating the conditions to improve a pension fund for the benefit of its members. It was only in 2006 that a slightly higher amount was allocated, and it was invested in overseas public listed equities. Global fixed income, real estate and fund of fund investments started four years later in 2010. In 2012, initial investment started in infrastructures projects overseas. Many countries have regulatory restrictions on investing overseas by public or private pension funds. Ministries of Finance or Central Banks

³² EPF 2018(b)

³³ Interview with EPF top management. 20 Nov 2017.

³⁴ Interview with Tan Sri Abdul Halim Ali. 22 Nov 2017.

are often concerned about the impacts of liberalization on the domestic capital market or the Balance of Payments. The Malaysia case shows that, carefully implemented, liberalization can be a strong positive for member returns. If the pension fund is growing then it is possible for the stock of assets to rise domestically whilst still adding external exposure.

The strategy to invest in overseas market was based on the following approach: start small with external management and then further develop with expertise brought in-house, while at the same time, ensure that all the building blocks are in place.

The tactic was simple, and it worked. The EPF would first allocate certain funds to be invested in selected overseas markets through external fund managers (EFM). Once internal capabilities and knowledge were developed, the internal team would start investing in the same market. For instance, in 2010, the overseas portfolio began to include global fixed income. Like public listed equities, the initial investment was made through externally managed mandates followed by the internal team. The internal team started investing in foreign public listed equities within the region in 2006, where they are more familiar and comfortable, while external managers invested in North Asia. Two years later in 2008, the internal team gained sufficient experience to work in North Asia as well. Investment in global Real Estate & Infrastructure began in 2010 with brown field investment; now this asset class includes developmental projects, such as the Battersea project in the United Kingdom. The strategy includes very large investments in specific locations rather than investing in a broadly diversified real estate fund such as a REIT. The investment in the Battersea project in the UK, for example, is worth 1.6 billion pounds.

What are the rationale for employing EFMs? There were multiple aims in engaging EFMs; they have in-depth knowledge and skill sets in overseas markets, allowing time for the EPF to build up internal capacity via knowledge transfer from the EFMs. Furthermore, the EPF was able to smooth overall returns as the EFMs were allowed to take more active risks than the internal fund managers. “Foreign skills are useful in investing in unfamiliar markets,” observed the current chairman, “and we also build internal capabilities, as we send our people to do attachments with external fund managers to learn new skills set³⁵”. Once the internal team gained skills and familiarity with the overseas markets, it undertakes its own overseas investments. Today, the returns on investments generated by the internal team are generally higher than those from the EFM. As of end-2016, investment in overseas markets (foreign equities, bonds, real estate and infrastructure) is equivalent to nearly 30.00% of the total fund size; the value has more than quadrupled the value of investment assets allocated overseas from RM43 billion to RM212 billion in the past six years.

Although EFMs continue to play a role in the EPF’s diversification strategy, nearly 85.00% of the entire fund is managed in-house, including overseas investments. Less than one-fifth of the entire fund is managed by the external fund managers. Investments in overseas markets, although started through external fund managers, are now mostly managed in-house, including investments in foreign equity. As at June 2017, about 60.00% of the exposure in foreign public listed equities is managed internally.

Overseas investments have gathered speed since 2006, as shown in Figure 5. By the end of 2017, internal fund managers have invested in almost 41 countries, from ASEAN to Europe to North America. All these trades are executed from Kuala Lumpur, as the EPF does not maintain any investment trading office overseas.³⁶

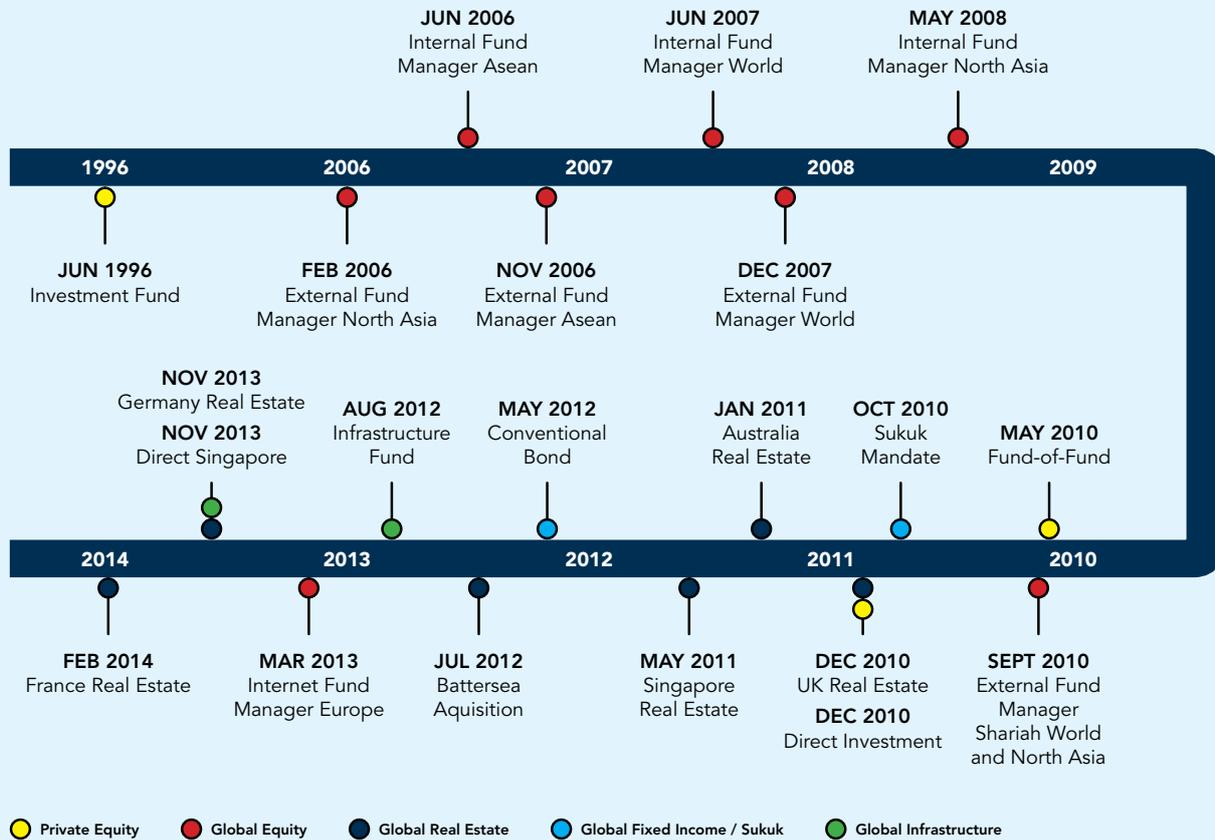
³⁵ Interview with Tan Sri Samsudin Osman. 23 Nov 2017.

³⁶ The EPF has a London office under KwasalInvest mainly for client relationship and monitoring purposes

FIGURE 5: Timeline: EPF's Investment in Foreign Markets

FOREIGN INVESTMENT

Key Milestones



Source: EPF (2017b).

The strategy to invest in overseas markets has produced respectable returns for the EPF (Table 3). As at December 2017, 28.00% of the EPF's asset is invested overseas while 14.50% is outsourced to the external fund managers. As at end 2017, the overseas investment has recorded a three and five year rolling ROI of 11.14% and 10.43% respectively. Meanwhile, the outsourced portion of the fund recorded a three and five year rolling ROI of 10.10% and 10.51% respectively. According to the EPF, had it maintained its investment purely in the domestic market, its overall return from investment would have been 340 percentage points less, assuming that the amount invested overseas can be invested domestically at the existing risk and return level. Aside from the benefits of diversification, overseas investments have also enhanced the EPF's overall investment returns. For the past three years, the overseas portfolio has recorded double digit annualised return of 11.10%, boosting the overall return by 1.39%.

TABLE 3: Nominal return on Investment, domestic and foreign, as at Dec 2016

	Domestic	Foreign	TOTAL
1YR (ROI %)	6.18	9.73	7.12
3YR Annualized (ROI %)	6.09	11.14	7.28
5YR Annualized (ROI %)	6.34	10.43	7.14

Source: EPF (2017b).

There are guiding principles in place for investment in overseas markets, and in asset classes, particularly in equities and fixed income, as explained below.

- **Overseas Market:** To have similar or better risk return profile, compared to domestic investment. Total assets allocated for investment in overseas market was capped at 20.00% in 2011 (it was 7.00% pre-2011 and was increased to 26.00% in 2014). Currently, the limit is set at 32.00%. The countries for investment are approved by the EPF Investment Panel, subject to the EPF Act 1991, and based on the stability of the economy and depth of the markets.
- **Equities:** To have stable dividend pay-out, strong annual performance/fundamentals (profit, sales, assets, net book value), growth potential, and market capitalization. For each investment, the equity stake must not exceed 15.00% of the listed company paid-up capital, and the EPF are not allowed to hold the majority of shares. The EPF management, both current and past, have stressed that "... the EPF can't be majority shareholders, as we are active traders".³⁷
- **Fixed Income:** To invest in only investment grade assets (BBB and above).

The Fund also maintains a healthy cash balance, to be deployed at appropriate times, such as "...when markets drop or during crisis, or when foreigners drive down prices in the domestic market"³⁸. As for the latter, the Fund acts as a market maker given its sheer firepower in terms of the local investment size. The cash balance is not used for smoothing of investment returns, as dividends are declared based on actual realized returns from investment on each particular year.

The investment strategy evolved slightly in 2015 when the EPF embarked on the environment, sustainable and governance (ESG) investing for its fixed income portfolio to ensure that it is in line with the fund's status as an ethical savings fund. In the same year, an internal team focusing on ESG research was established to study the optimality in extending the ESG principles to domestic equity investment.

37 Interview with Tan Sri Abdul Halim Ali. 20 Nov 2017.

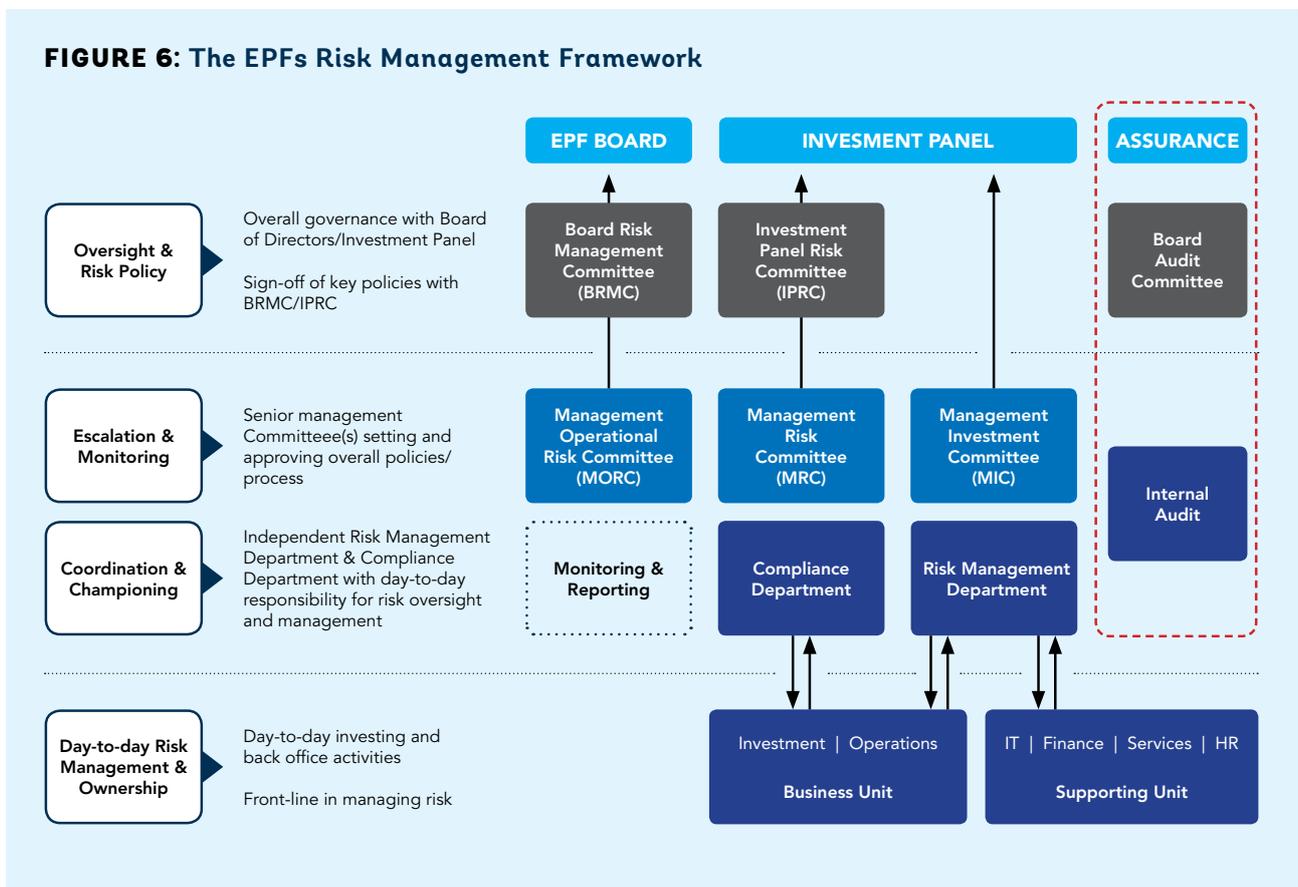
38 Interview with EPF top management. 20 Nov 2017.

There are certain criteria for consideration when the EPF investment team evaluates investment strategies. The investment decisions must satisfy these requirements:³⁹

- Strategic role of the asset class/sub-asset class in the asset allocation strategy;
- Sufficient size, liquidity and cost efficiency (tax structure) to permit meaningful amounts in that asset class/sub-asset class, and to have a material effect on the EPF’s returns;
- Investment has the effect of reducing overall portfolio risk;
- Improves expected return of the total portfolio, and the ability to generate realized returns which is what the EPF needs to declare its dividend;
- Availability of sufficient internal or external investment and technical expertise to ensure prudent implementation of an investment in that asset class/sub asset class.

Risk Management Framework

The implementation of a multi-asset class portfolio in multiple countries requires a sophisticated risk management system. The EPF has developed the sophistication and depth of its risk management framework over the years in order to support the greater reach and complexity of the investments. As highlighted in Figure 6 there are multiple layers to the framework that are integrated to the overall governance framework outlined above. Greater details are presented in the EPF’s Annual Report.



39 EPF (2016a).

Role of capital market development

Pension funds that are large relative to their domestic capital market face a challenge to find sufficient investments for their capital – although even so many still retain over 90.00% in domestic government bonds even when there are more opportunities (Stewart and Price, 2018). However, the ability to diversify is clearly helped if there is a proactive policy from the government and regulators to expand the range of capital market instruments into which funds can invest. Mexico, for example, saw a very significant development over time of the range of investment instruments for institutional investors of all kinds – which supported the gradual liberalization of investment restrictions on private pension funds, whose investment allocations went from close to 100.00% in government bonds when the system was launched in 1997 to a far greater diversification domestically and internationally now. Malaysia had a similar proactive process of developing the capital market, and the EPF played an important role as an early investor to help take advantage of new opportunities for its members, which also helped to create the market. The development of the Malaysian capital market over the past 15 years has hence helped support the EPF's developing investment strategy. The details and lessons of these development is an important area for research to provide the right lessons for other countries and will be addressed in future work.

It is worth noting that the EPF's investment cost is low – cost to total assets is 0.17%, and the cost to asset under management is 0.26% in 2017.⁴⁰ In other words, for every RM1,000 in investment, the cost for the EPF is just RM2.60 (equivalent to a quarter of the price of a Starbucks coffee!). Reflecting the focus on using in-house resources, the total fees paid to external fund managers in 2016 were only 4.50 basis points (0.045%) of net assets under management.⁴¹

While the investment strategy has produced commendable returns, especially through diversifying to foreign markets and investment in new asset classes, the building blocks for such success were placed much earlier. In particular, operational efficiency and sound corporate governance contributed largely to the Fund's development. These two factors will be further explained in the following section.

⁴⁰ Interview with EPF top management. 20 Nov 2017.

⁴¹ 2016 Annual Report, note 29 on Investment Expenditures

Operational effectiveness

The critical factor that contributed to the EPF's success in terms of operational effectiveness is the professionalism of its employees, and the continued focus on their customers, i.e. the members.

Strong Leadership & Integrity

Based on the interviews conducted, it becomes clear that the strength of the EPF originates from the professionalism and the skill sets of its employees. The reform in the late 90s and the first few years of the new millennium transformed this government agency into a more professionally-run outfit. The organisation structure was reformed to ensure professionalism and instil trust among employees and members. Pre-2001, the EPF was run by an Executive Chairmen who were former senior government servants. In 2001, the position of the Executive Chairman was abolished, and replaced with a Chairman and a CEO posts to ensure check and balance. Abdul Halim Ali was appointed as the EPF Chairman from 2 February 2001 to 31 January 2007 and was formerly the Chief Secretary to Government of Malaysia before his appointment. Azlan Zainol, an ex-corporate banker, was appointed as EPF's CEO from 16 April 2001 to 8 April 2013. Azlan Zainol was formerly the Managing Director of AmBank Berhad from August 1994 to April 2001.

According to Azlan Zainol, the key reform started when Dr Roslan Ghaffar, an economics professor from University Putra Malaysia, joined the EPF as Director of Investment and Economic Research in the late 1990s (he retired in 2007). He was instrumental in changing the prevalent work culture. While it is not unusual for government employees to leave work by 5pm, Dr Roslan would "instead challenge the norm and the culture"; for instance, he would start staff meetings at 7:15pm.⁴² He also started to attract local expertise from the private sector to join the Fund, and changed the remuneration system.

When Azlan Zainol joined as CEO in 2001, he continued the trend. The legal status of the EPF was also changed from being just another government department that followed civil service process and procedures in terms of recruitment and remunerations, to become a statutory body, alongside the Income Tax Department, Social Security Organization (SOCSO), and the Pilgrimage Fund (Tabung Haji). This was key in attracting talent, as with the new status, it automatically allowed the EPF to hire or fire directly, and set its own remuneration system, among others. This paved the way for the EPF to recruit industry professionals and reward staff based on performance. The current employee remuneration at the Fund is now almost at par with the industry, and in some cases, better than industry. Performance is recognised and deserving promotions accelerated.

The entry of Azlan Zainol and his leadership accelerated the change of the Fund to become a professionally run outfit, and according to Abdul Halim Ali, who served as Chairman during this time, Azlan Zainol "ran the EPF like a bank"⁴³ (implying efficiency and professionalism). Among the first things that Azlan Zainol did after assuming office was establish the trust of the employees by demanding professionalism from the staff. It was common knowledge that he regularly visited EPF branches all over the country and interestingly, one of the first things he would do was to check the storeroom and the rubbish bin to ensure that documents were properly filed and important documents shredded and correctly disposed of. Professionalism was demanded at all times, and to ensure that operations were focused on the EPF mandate, he employed an IT person (who was formerly from a financial institution) to improve the entire

⁴² Interview with Tan Sri Azlan Zainol. 20 Nov 2017.

⁴³ Interview with Tan Sri Abdul Halim Ali. 22 Nov 2017.

computer system. He modernized the ICT infrastructure at an approximate cost of RM200 million, a sizeable sum at that time.

In fact, part of the EPF's success today is due to the infrastructure that was put in place by Azlan Zainol. Further changes took place for the EPF's human resources, when a Programme Management Office (PMO) was established and placed in his office, to establish work plans with the mandate to help coordinate operations across departments. Among the major initiatives introduced was to resize, or "right size", the Fund's operations. Staff were redeployed, and new skills and relevant competencies were identified for retraining. The Fund continues to invest heavily in developing its human capital; employees across divisions and at the branches are regularly sent for training. For an organization that manages something as socially-sensitive as retirement savings for the formal working population of Malaysia, the EPF management takes the view that "skill sets matter".⁴⁴

Apart from building up human capital, Azlan Zainol demanded that employees practise the highest level of integrity. To show that he was serious and meant business, within a year of his appointment as CEO, an employee was charged and sent to jail for breaking the law.⁴⁵ The importance of integrity has been consistently raised and mentioned by all past and present Chairmen and CEOs during our interviews; all had the same common understanding that "reputation is key"⁴⁶ and that staff integrity was of paramount importance for members to trust that the EPF is always looking out after their interest. In late 2015, the Fund signed the Corporate Integrity Pledge (CIP) witnessed by the Malaysian Anti-Corruption Commission.

Additionally, unnecessary spending and wastage were minimized, a trend that was started by Azlan Zainol when he refused to allocate a sizeable sum for the company annual dinner as he, and the current EPF management, believe that this is not appropriate expenditure given that they are managing people's hard-earned money. Expense on any activity that does not provide returns, either directly or indirectly to the EPF, is generally not allowed nor approved, including donations. As mentioned by the current top executive "...one ringgit spent on donating to charity means one ringgit less for the members". It is worth noting that the entire corporate social responsibility (CSR) allocation of the EPF is capped at RM50,000 per year, a very small amount for an organisation that manages nearly RM800 billion.

During Azlan Zainol's tenure, small but meaningful changes were implemented, such as to ensure that the counters remained open during the Friday prayers, albeit with lesser staff (previously counters were closed for two hours during Friday prayers). The Fund continued to transform after Azlan Zainol's departure in 2013. Since taking over the helm, current CEO Shahril Ridza Ridzuan has introduced online and e-services for members, as well as flexible benefits, flexible time and flexible workplaces for staff. The focus on enhancing skill sets, professionalism and integrity continue to be top priorities.

The process in ensuring that the EPF performs and delivers its mandate is quite inclusive. Every year, top management conducts six to seven town hall sessions with employees to gather feedback, as well as to share ideas on ways to improve the performance and operations of the Fund. The management takes the opportunity to consistently remind the employees of the vision and mission of the organization. The employees are pressed to deliver solid performance and are encouraged to have "pride in delivery".⁴⁷ Not surprisingly, staff turnover at the EPF is low – less than 5.00%,⁴⁸ which is particularly remarkable for an investment organization, which generally tends to have high staff turnover.

44 Interview with EPF top management. 20 Nov 2017.

45 Ibid.

46 Ibid.

47 Ibid.

48 Ibid.

Focus on customers

The focus on customers, as demonstrated in the second part of the mission statement “deliver excellent services” is central to the success of the EPF. There was a huge reform post-2003, when a customer service department was established to act as a single point of information for the whole fund. Previously, information was referred to and from individual departments. The aim was to deliver consistent information to the public fast. Customer-friendliness training continued and was expanded with special emphasis for counter personnel. Counter clerks and those at the front line are sent for grooming and etiquette classes (“must smile”), and customers would rate them after each session via an electronic notepad placed at the counter.

A one-stop centre concept was also introduced, where all EPF-related businesses could be transacted at a single branch. E-Kiosks are placed in all EPF branches and at various banks, where members are able to obtain all relevant information on their own and print statements at these unmanned kiosks. The list of the initiatives in enhancing quality of services is highlighted in Table 4 below.

TABLE 4: Initiatives in enhancing quality of services⁴⁹

No	Initiative	Description
1	MyEPF	Members can log onto their interactive website for information and online services
2	Contact Management Centre (CMC)	Centralised centre for information by telephone, fax, email and social media (a one-stop contact centre)
3	Customer-friendly service Programme	Introduced training programmes for customer service friendliness, with emphasis on counter services
4	Contribution by internet	Member can now make contributions online
5	EPFnet	EPFnet is an internal IT server that hosts all the relevant information. It is an interconnected and integrated system for all EPF operations

Source: EPF (n.d.)

At the centre of all these initiatives is the i-Akaun platform, which was introduced in 2004 to enhance customer convenience, lower operation cost and manpower.⁵⁰ As of 2017, 34.00% of the 13 million members have an i-Akaun, and the EPF aims to increase the percentage to 90.00% by 2021.⁵¹ This online system allow members to undertake various transactions online such as checking their statements and apply for withdrawals, and for employers to make monthly deductions or submit workers details online without the need to go to the banks or EPF branches. The features of the i-Akaun are listed in Figure 7. In 2014, as smartphones gained more popularity as a new and alternative method of interaction, the EPF introduced the EPF Mobile App, for members to download and access their EPF information via their own mobile phones.

49 EPF. n.d. EPF Website. Kuala Lumpur: EPF. Available from <http://www.kwsp.gov.my>.

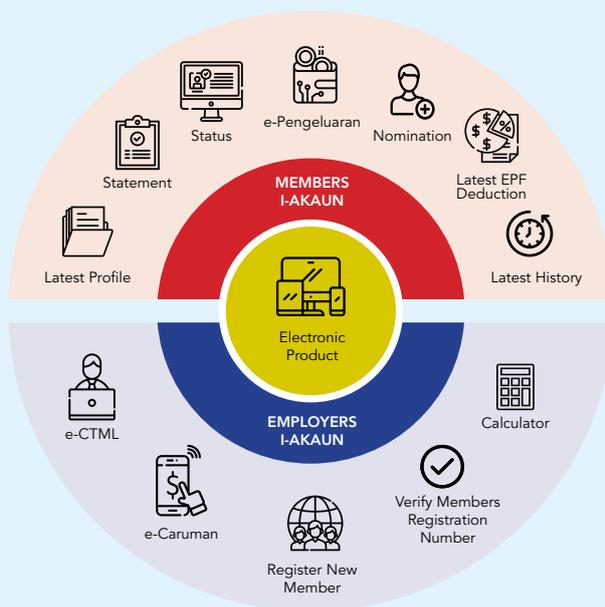
50 EPF (2016a).

51 Ibid.

The Fund also entered social media rather early on, in 2010, “to reach out to a larger and broader range of audience and to leverage quick, accessible information exchange”.⁵² As of early 2018, the Fund’s Facebook account has roughly 720,000 followers (more than California Pension Fund’s Facebook account); a big jump from 15,594 followers in 2010. The Fund’s Twitter account has nearly 8,000 followers.

FIGURE 7: Features of i-Akaun

Features of i-Akaun for members and Employers



MEMBERS I-AKAUN

- To apply for e-Pengeluaran
- To check on current year and past year EPF statements
- To check on the current status of withdrawal and history of withdrawal
- To check on beneficiary status
- To calculate on the eligibility of withdrawal, savings and investment
- To update latest profile which includes home address
- To check on the latest EPF deduction
- To check on the activity log of i-Akaun

EMPLOYERS I-AKAUN

- Utilising e-Caruman services
- Using e-CTML services
- Registering new EPF members
- To verify EPF members registration number
- To check on the latest EPF deduction
- Accessing and calculating dividend shares for government employer

“As at December 2016, a total of 3,934,318 million members and employers have activated their i-Akaun.”

Source: EPF (2017b).

There are strict KPIs imposed in ensuring that the the delivery is speedy and accurate. The EPF has a pledge, known as *Janji Kami* (“Our promise”), as shown in Figure 8. It is a promise that certain transactions will be carried out within a certain time limit. For instance, it pledges to credit the yearly dividend payments to members account within a day after the dividends are declared (which they have consistely done). Additionally, waiting at the counter is promised to be no more than 15 minutes during peak hours, phone calls would be answered in 10 seconds, disbursement of housing withdrawals would be within 15 working days, and other high benchmarks, which the EPF consistently meets.

52 EPF. 2012. Annual Report 2011. Kuala Lumpur: EPF.

FIGURE 8: EPF's Pledge



Source: EPF (2017b).

These changes have been well received by the members, and the Fund has been making progress towards modernising its interactions with members as shown in Table 5 below.

TABLE 5: Interactions with members, 2014-2016

Channel		2016	2015	2014
myEPF	+	23,395,195	17,533,045	12,659,814
Kiosk	+	13,212,420	10,456,700	9,310,677
i-Akaun		18,807,071	12,655,924	7,275,364
Counter	-	4,361,281	4,768,671	5,130,451
Contact Management Centre (Telephone)		1,346,667	997,491	853,886
Contact Management Centre (Email)	+	79,254	55,813	48,246
TOTAL		61,201,888	46,467,644	35,278,438

Source: EPF (2017b).

The most recent initiative to enhance customer service, as well as to help members with their retirement plan, was the introduction of the Retirement Advisory Service (RAS), where nearly 100 trained EPF employees have been placed in selected branches in every state in Malaysia to advise members on sustainable retirement plans. There are currently 28 RAS counters nationwide, and the service is available free of charge. The EPF's RAS has received international attention, and the Fund was given an award for this initiative at the World Pension Summit Innovation Awards 2016.

Simpanan Shariah

There is also a new and innovative product introduced for the members, which is the first of its kind in the world: *Simpanan Shariah*, where members can opt to convert from their current conventional savings account to one that is managed and invested in accordance with Shariah principles. It was introduced in 2016, after the EPF conducted a nationwide survey where nearly 71.00% of its members who participated in the survey expressed interest in having Shariah compliant retirement savings option. As of end-2016, a total of nearly RM60 billion of the initial RM100 billion fund allocated for *Simpanan Shariah* have been taken up and 635,037 members have switched to *Simpanan Shariah*.⁵³

As at end-2016, out of the Fund's total investment assets, about 48.00% is Shariah compliant investments and the balance are invested in non-Shariah compliant assets. It is worth noting *Simpanan Shariah* is open to all members, regardless of religion. However, unlike the conventional account, which has a guaranteed dividend of 2.50% per year, *Simpanan Shariah* does not have a guaranteed dividend in accordance to the principles of Shariah, and the dividend rates would be based on the portfolio performance of Shariah compliant investments. According to the EPF, the variance in the overall returns between the conventional account and *Simpanan Shariah* is expected to be about 0.50% or 50 basis points over a 20 to 30-year investment horizon.⁵⁴ Shariah funds are known to perform well in a volatile economy.

53 The Star. 2017. "EPF: More than half of Simpanan Shariah fund taken up". 18 Jan 2017. Available from <https://www.thestar.com.my/business/business-news/2017/01/18/epf-more-than-half-of-simpanan-shariah-fund-taken-up/#B3URle0RIBFY7xz7.99>

54 On 10 February 2018, the EPF declared the first dividend rate of 6.40% for Simpanan Shariah, and 6.90% for the conventional savings.



CHAPTER 3

Future Challenges

While the EPF has done well, especially in the past one and a half decade, there are several existing and new challenges that demand new strategies and approaches.

Ageing nation

The first challenge – typical and applicable for all pension funds – involves demographic changes, where Malaysia as a nation is getting older. The country is forecasted to reach ageing nation status by 2035, when persons older than 60 years will account for 15.00% of the population, up from 7.80% in 2010.⁵⁵ The speed of increase of persons older than 65 years over that 25-year period is greater than in many other countries. For instance, it will take the Philippines 35 years to increase its share of older people from 7.00% to 14.00%, 40 years for South Africa, whereas it took 45 years for the United Kingdom, 69 years for the United States, 85 years for Sweden and 115 years for France.⁵⁶ Two factors are driving the ageing population: a longer life expectancy and the falling fertility rate. The average life expectancy at birth was 72.50 years for males and 77.4 years for females in 2015, which was an increase from 55.80 years and 58.20 years, respectively, in 1957, when Malaysia gained its independence.⁵⁷ At the same time, the total fertility rate (TFR) steadily declined from 4.90 births per woman in 1970 to two births per woman in 2014, slightly below the replacement rate.⁵⁸

This would spell trouble for the EPF, as it will have challenges in meeting its vision of “helping members achieve better future”. The reason is this: while the workers are living longer, the retirement savings withdrawal age for members’ remains at 55 years, unchanged since 1952. When compared with other industrialized and developing countries, the retirement age in Malaysia is low; the retirement age in Singapore is 62 years and the Philippines is 65 years. The low retirement age and high life expectancy leads to a life expectancy-pension gap, and compared to other countries in the region, the life expectancy-pension gap in Malaysia is 19.20 years, while in Singapore it is 18 years, 15.70 years in Indonesia, 15.60 years in Thailand and 6.70 years in the Philippines.⁵⁹

The demographic changes would not have been such an issue if Malaysia had a universal social pension, or the replacement rate was high, but that is not the case. In Malaysia, the gross replacement rate is quite low; especially among female workers where it is an estimated 31.90% while for male workers it is estimated at 35.10%.⁶⁰ The low replacement rate makes it hard for pensioners to maintain their previous lifestyle or standard of living. While the replacement rate in Malaysia is higher than in Indonesia (at 19.00%), it is still much less than in the Philippines (at 79.00%) or the Republic of Korea (at 50.00%).⁶¹

While the contribution rate is high, almost 24.00%, it does not translate to high absolute pensions or high replacement rates. This is due to three reasons: firstly, majority of the EPF members earn low salary. The median salary for workers in Malaysia in 2016 is RM1,700, which is about 1.7 times higher than minimum wage. Secondly, there are ‘leakages’ before the official withdrawal age. As mentioned earlier, withdrawal is allowed prior to retirement – specifically for buying a house, for health and education expenses. Finally, the ‘density of contributions’ is not 100.00% for many workers meaning that they are not able to contribute every year. This is one reason behind the large difference between total accounts and active accounts highlighted above.

55 DOS (Department of Statistics). n.d. Population Quick Info. Putrajaya: DOS. Available from <http://pqi.stats.gov.my/searchBI.php>.

56 EPF (2016b).

57 DOS (n.d.).

58 Ibid.

59 ADB (Asian Development Bank). 2015. Pension Systems and Old-Age Income Support in East and Southeast Asia Overview and Reform Directions. Manila: ADB. Available from <https://www.adb.org/sites/default/files/publication/29392/pension-systems-old-age-income-support.pdf>

60 OECD. 2012. Pensions at a Glance: Asia Pacific Edition. Paris: OECD.

61 Ibid.

As it stands, the adequacy for those nearing retirement is troubling. Nearly seven in 10 EPF members aged 54 had less than RM50,000 in savings, with the poorest 20.00% having an average savings of only RM6,909.⁶² Assuming they live until the age of 75, they can only spend about 96 cents (USD0.68) per day, or about RM29 (USD20) per month, below the RM1,000 cut-off poverty line, from the age of 56 to 75.⁶³ This is clearly insufficient for retirement. Only 8.30% of the EPF members aged 55 had at least RM196,000 in their pension account as of 2015, which is the recommended minimum savings level needed to sustain them until the age of 75. This is not surprising, because they earn so little. As of end-2015, around three in four EPF members (76.00%) earned less than RM3,000 per month, and nearly 90.00% earned less than RM5,000 per month.⁶⁴ It will be important to ensure that members' savings stay invested for longer and are not taken out at the earliest possible age but kept invested until closer to Age 65. A combination of a longer period to accumulate savings and a shorter period over which they will be needed, would significantly improve the income stream from the EPF. Further a default pay-out option that provided an income until death would be preferable to ensure income security in very old age.⁶⁵

Inadequate coverage

Financial awareness for retirement is seriously lacking. Data from the EPF shows that about 71.00% of EPF members aged 55–60 years opt for lump-sum withdrawals of their pension savings upon retirement; and 50.00% of members exhaust their savings within five years.⁶⁶ Therefore, these demographics changes require a revamp of the current model to ensure that members and the elderly are financially independent post-retirement.

The second challenge is to provide coverage for workers. As of end-2017, only a little more than half of workers in the labour force are contributing EPF members, which means that the other half (of the labour force) have no old-age pension coverage at all. Most people without any pension or retirement scheme coverage are the self-employed or among the informal economy, as they are not mandated to contribute to the EPF. Further, the number of workers without EPF coverage has increased, from 5.5 million in 2006 to 7.7 million in 2015 as shown in Figure 9. The percentage of the employed labour force without an active EPF account has likewise increased from 54.00% to 55.00% during same period.

A reform agenda needs to be looked at, in order to expand coverage particularly for the self-employed. One option is to subsidize low-income self-employed workers, where their contributions are partly financed by the state. Countries such as Indonesia, Vietnam, South Korea and China, for instance, are subsidizing the contribution to expand pension coverage to self-employed workers.⁶⁷ In Malaysia, incidentally, the government has initiated the 1Malaysia Retirement Savings Scheme (SP1M) to ensure that those who are self-employed and do not earn a regular income achieve a certain level of savings upon reaching the retirement age. Members who save under the scheme shall receive Government contribution of 15.00% on the amount contributed, subject to a maximum of RM250 a year for a period of five years from 2018 to 2022. However, the take-up rate is low, as at end 2017, only 90,599 informal sector workers participated in the program, or about 1.20% of total workers in the informal sector.

62 EPF (2016b).

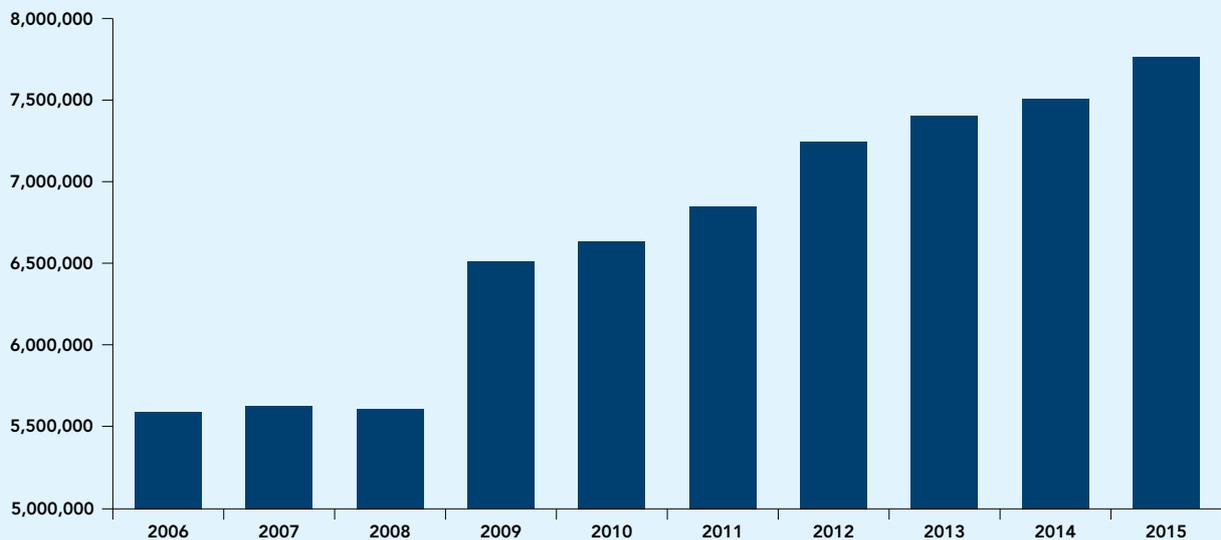
63 DOS. 2015. Household Income and Amenities Survey 2014. Putrajaya: DOS. Note: A household is considered poor if the monthly household income is below the following cut-off point: a) for households in urban areas: RM940 in Peninsular Malaysia, RM1,160 in Sabah and RM 1,040 in Sarawak, and b) for households in rural areas: RM870 in Peninsular Malaysia, RM1,180 in Sabah and RM920 in Sarawak.

64 EPF (2016b).

65 Price, W. and E. Inglis. 2017. "Paying the Pension: Markets, Products and Choices", in *Saving the Next Billion From Old Age Poverty: Global Lessons for Local Action*, ed. P. S. Khanna, W. Price and G. Bhardwaj. 2017. Singapore: Pinbox Solutions.

66 Ibid.

67 MacKellar, L. 2009. L. Pension systems for the informal sector in Asia. Social Protection & Labor Discussion Paper (No. 47679). Washington, D.C.: World Bank. Available from <http://siteresources.worldbank.org/SOCIALPROTECTION/Resources/SP-Discussion-papers/Pensions-DP/0903.pdf>.

FIGURE 9: Total number of workers without EPF coverage

Source: EPF (2016a).

The third and fourth challenges – and these are based on the interviews with the management – are to maintain public trust, and to stay relevant. For the former, public trust must be protected at all costs and as the current Chairman observes, “the key ability of the EPF to maintain its professionalism, efficiency and integrity is because we have good people who value integrity and honesty”.⁶⁸ There is also a need to stay relevant, especially in the phase of fourth industrial revolution and artificial intelligence, and the EPF must be able to satisfy new members, such as those in the gig economy, who have different needs and demands.

⁶⁸ Interview with EPF top management. 23 Nov 2017.



CHAPTER 4

Conclusion

This case study of the EPF has identified a number of critical factors that has helped to transform the EPF over the past 20 to 30 years. Of central importance was the creation of a governance structure that focused on developing an expert management team that operates with oversight from a supervisory or governing board that contains representation from different stakeholders. This enhanced insulation from the political interference, the focus on the long-term interests of the EPF members, and the commitment to ensure people with the right talent and skills are in the key positions are the fundamental building blocks to allow the organization to perform well.

The case study also shows how these developments rely on the personal leadership of people in key positions. Instigated by the Minister of Finance in 2003 taking a long-term view, this journey began with the separation of roles between the Chairman and CEO, enhancement of the governance model, bringing in talented people and allowing overseas investment. This all happened some 50 years after the organization was initially founded and mirrors the picture of a pre-reform and post-reform entity as illustrated in a recent case study of the Canadian Pension Funds.⁶⁹ Leadership is as important in the policy and legal environment under which the Fund operates, as well as delivering the core mandate when expert management are given the freedom to find the best solutions to meet this critical mission.

Finally, the case study shows how a disciplined process to create and execute a long-run investment strategy driven in the best interest of its members can achieve strong results. Moreover, as the EPF funds grew in size, it was able to exploit the economies of scale in administration and investment that enabled costs to reduce significantly as a share of assets under management to enhance net of fee returns, while still providing significant resources to invest in IT systems, risk

management and staff. It also shows how the right solution to investment execution can evolve over time as the Fund gains scale, expertise and experience. The 'right' solution is not static, and a Fund should continually evaluate the mix between in-house and external investment implementation – driven by its focus on what would be the best approach to maximize returns to members.

In common with many countries and pension institutions the EPF and the Malaysian pension system of course face many challenges and will need to continually adapt to face demographic challenges from rising longevity and falling birth rates. As highlighted above key challenges include ensuring more of the assets remain in the EPF for longer rather than being withdrawn at 50 and 55 so that ultimate balances are higher and have to fund fewer years of retirement. Moreover, Malaysia will need to ensure broader pension coverage, particularly of workers in the informal labour market. This is perhaps the biggest challenge in modern pensions. These issues and many others will be critical in completing the social protection and retirement system in Malaysia – but are the subject of future research and investigation. Likewise, the story behind the development of the capital market in Malaysia, and the role of the EPF in the development of new and broader instruments is also an important topic – but again one that is beyond the scope of this case study and will be covered in future work.

The important lessons from this case study of the EPF – changes from the policy environment, stringent governance process, developing expertise, a clear focus on the best interest of members, and exploiting economies of scale in administration and investment – should be useful to a wide range of audiences interested in improving the performance of pension funds, or interested in starting their own journey of setting up a retirement savings scheme.

⁶⁹ Commonwealth and World Bank. 2017. The Evolution of the Canadian Pension Model: Practical Lessons for Building World-class Pension Organizations. Washington D.C.: World Bank.

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Appendix

List of Individuals Interviewed

1. Tan Sri Abdul Halim Ali – Chairman [2001-2007]
2. Tan Sri Azlan Zainol – CEO [2003-2013]
3. Tan Sri Samsudin Osman – Chairman [2007- current]
4. Datuk Shahril Ridza Ridzuan – CEO [2013-current]
5. Dato' Mohd Nasir Ab Latif – Deputy CEO (Investment) [current]
6. Tunku Alizakri Alias – Deputy CEO (Strategy) [current]



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