



# Policy Advisory

No. 2008-07

## **REFORMING THE PRE-NEED INDUSTRY: A REVIEW**

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**Congressional Planning and Budget Department  
House of Representatives**

## EXECUTIVE SUMMARY

*The pre-need plan was conceptualized as a savings mechanism to secure future needs. Pre-need companies (PNC's) offer plans that provide for future educational costs, pensions upon retirement, and memorial services upon the demise of its planholders. The industry enjoyed unprecedented growth in the early years of its introduction in the market. However, lately its viability as an industry has been tarnished because of the inability of a number of PNCs to fulfill their obligations to their planholders.*

*Among the causes of the collapse of the pre-need industry are the following: (i) deregulation of tuition fees in 1992 that led to the skyrocketing of such fees; (ii) lower interest yields on trust fund investments due to the 1997 Asian financial crisis; (iii) weak regulation; (iv) inappropriate accounting practice; (v) collusion among pre-need companies and their affiliates; and corporate indiscretion.*

*To protect the interest of planholders and ensure sustained growth of the industry, there is a need to address the ills plaguing the pre-need industry to avert its full-blown collapse. Reforms should include the following:*

- *Conduct rigorous independent audit to determine which PNCs remain viable. Licenses of those that fail the audit should be revoked by SEC and placed under receivership.*
- *Create a "Holding Company" (HoldCo), to rehabilitate bankrupt pre-need firms and make planholders co-owners by converting their plans into equity.*
- *Promote tripartite agreement among planholders, PNCs and SEC to restate and reduce the maturity values of traditional educational plans to reflect realistic investment return assumptions, convert the difference between the original and revised maturity values into equity in HoldCo and require the shareholders of distressed PNCs to subscribe to additional capital in*

*HoldCo, and institute fundamental changes in the corporate governance of the surviving PNCs.*

- *Establish a Pre-Need Plan Code to serve as a legal framework that will oversee and regulate the industry.*
- *Transfer the supervision of the pre-need industry to the Insurance Commission which has the capabilities and the expertise in regulating the industry.*
- *Promote and develop a secondary market for pre-need plans to enhance their value to planholders and their overall attractiveness as a savings and investment instrument.*

*The growth of the pre-need industry strongly depends on trust and confidence. The Philippine experience shows that excesses and failure of one or two pre-need companies can have serious repercussions on the whole industry. In this regard, sound rules, and regulatory and supervisory structures that will govern the activities of the pre-need companies and assure the stability of the industry, and at the same time protect present and future plan-holders, should be institutionalized.*

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# REFORMING THE PRE-NEED INDUSTRY: A REVIEW

*By Diomedes D. Goboleo*

## INTRODUCTION

The *pre-need plan* was conceptualized as a savings mechanism to secure future needs. Pre-need companies (PNC's) offer plans that provide for future educational costs, pensions upon retirement, and memorial services upon the demise of its planholders. It is viewed as an alternative mode of investment for families with modest means.

Pre-need plans enjoyed unprecedented growth in the early years of its introduction in the market. Industry sales grew 127% between 1994 and 2001. Sales performance peaked in 2001, reaching 675,187 plans sold with an aggregate value of P38.67 billion.

The pre-need industry is crucial to the economy because it helps mobilize long-term savings, as evidenced by the accumulated trust fund of P94.27 billion as of December 2006. However, its viability as an industry has been tarnished because of the inability of a number of PNC's to fulfill their obligations to their planholders, mainly because of certain educational plans that in time have become incompatible with the present policy environment, the excesses of pre-need management, and weak regulation.

## INDUSTRY PROFILE

There are three types of pre-need plans:

- **Educational plan** – this type of plan seeks to cover the cost of college education of the beneficiary as stipulated in the contract be it either open-ended or fixed amount. In the traditional or open-ended educational plan, cost refers to the actual 4-year college tuition fees at the time of the utilization of the plan by the beneficiary. College Assurance Plan (CAP) pioneered the traditional or open-ended educational plan. This type of plan however, which at first glance seemed to be a sound business model, expose pre-need educational companies to heavy losses under the recently deregulated tuition fee environment.
- **Pension plan** – this is a fixed value plan with guaranteed interest income upon maturity.
- **Life plan** – covers memorial services at the time of death of the beneficiary.

The pre-need industry has a total of 5 million planholders, 5% of which own educational plans. Over the last 25 years, a cumulative total of 91 pre-need companies have been registered with the Securities and Exchange Commission (SEC). As of December 2006, the number of pre-need companies with dealers license authorizing them to sell pre-need plans has dwindled to only 30; 20 ceased to exist as corporations because of merger and consolidation or voluntary dissolution. Another 30 temporarily ceased operations either due to failure to secure renewal of dealer's licenses,

suspension or revocation. Five are under liquidation and another five are in the process of rehabilitation. The pre-need companies that are under rehabilitation are: College Assurance Plan, Pacific Plans, PET Plans, Platinum Plans and TPG Corporation (*Table 1*).

**Table 1**  
**Status of Pre-Need Plan Companies**  
**As of December 2006**

Status	Number
A. Companies with 2006 Dealer's License	30
B. Inactive (without dealer's license)	30
C. Companies that have ceased as a corporation	20
C. Under rehabilitation	5
D. Under liquidation	6
<b>Total</b>	<b>91</b>

*Source: Securities and Exchange Commission*

To insure the liquidity and stability of the trust funds of PNC's, the Securities and Exchange Commission (SEC), prescribed the following investment portfolio mix: 10% should at least be invested in government securities, 15% in commercial papers issued by top grade companies, 5% for direct loan, 25% for equities, and 25% for real estate investment. These are the allowable limits the trustee banks can invest the funds to guarantee the due diligent management of the trust fund.

The total trust fund investment portfolio of the pre-need companies as of December 2006 amounted to P94.27 Billion. The government is

the biggest beneficiary with P57.28 Billion or 60.8% of the trust fund being invested in government securities. This was followed by investments in equities and real estate with 15.6% and 7.6% respectively. Other investments (mutual funds, common trust fund, etc.) cornered 16.7% of the trust fund portfolio (*Table 2*).

**Table 2**  
**Trust Funds Investment Portfolio of**  
**Pre-Need Companies, as of December 2006**  
**(in Billion Pesos)**

Component	Amount	% to Total
<b>Total</b>	<b>94.27</b>	<b>100.00</b>
Government Securities	57.28	60.8
Equities	14.71	15.6
Real Estate	7.13	7.6
Other Investments	15.15	16.1

*Source: Securities and Exchange Commission Annual Report*

## **THE COLLAPSE OF THE PRE-NEED INDUSTRY**

The College Assurance Plan's (CAP) traditional or open-ended educational plan has become an overnight success because it fills a need close to the heart of the planholders coupled with the assurance of covering its beneficiaries' college tuition fee at future costs. Other pre-need educational companies followed suit by imitating CAP's perceived sound business model.

Pre-need educational companies were hardly cautious of the deregulation of tuition fees in 1992 even as their obligations were

starting to mount because of the increasing tuition fees. Some resorted to selling even more and more educational plans and used the proceeds to pay off maturing plans. This resulted to the increasing growth of year-on-year sales of pre-need companies, until a decade later when the adverse impact of deregulation eventually caught up with companies offering open-ended educational plans. By 2002, sales started to tumble. So did the number of plans sold.

**Table 3**  
Summary of Plans Sold and Pre-Need Sales  
By Type of Plans, 2000-2006

<i>Number of Plans Sold</i>								
<b>Plan Type</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Education	208,438	227,884	195,176	141,944	129,383	49,439	32,878	24,603
Life	82,186	88,989	73,776	110,870	124,621	114,708	87,365	107,070
Pension	291,379	358,314	343,620	280,734	253,828	138,451	123,203	97,279
<b>Total</b>	<b>582,003</b>	<b>675,187</b>	<b>612,572</b>	<b>533,548</b>	<b>507,832</b>	<b>302,598</b>	<b>243,446</b>	<b>228,952</b>

<i>Pre-Need Sales (in Billion Pesos)</i>								
<b>Plan Type</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Education	17.03	15.00	13.30	12.39	13.30	5.66	4.04	3.80
Life	1.90	2.70	2.09	2.94	4.20	3.79	3.13	4.07
Pension	17.20	20.97	22.48	17.40	19.40	11.00	12.36	11.02
<b>Total Sales</b>	<b>36.13</b>	<b>38.67</b>	<b>37.88</b>	<b>32.74</b>	<b>36.90</b>	<b>20.45</b>	<b>19.53</b>	<b>18.89</b>

Source: Securities and Exchange Commission

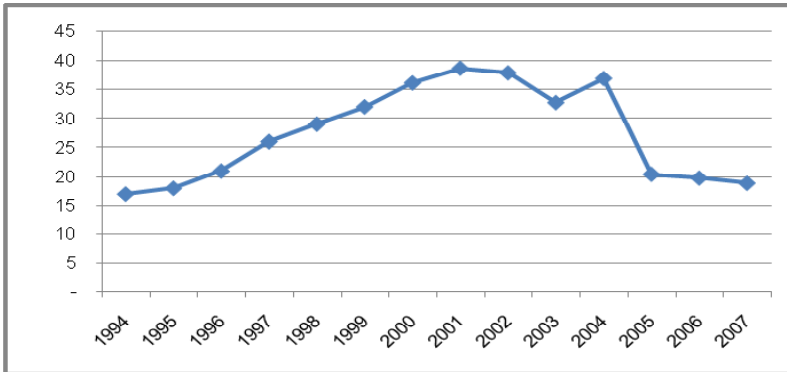
Educational plan sales dropped 77.69% from P17 billion in 2000 to just P3.8 billion in 2007. In terms of the number of plans sold educational plan sales declined by 88.2%. Likewise pension plans

sales declined by 36% from P17.2 billion to P11 billion or in terms of the number of plans by 67%. However, life plans managed to post positive sales growth of 114% for that same period, but from the period 2004-2006 sales declined by almost 26%. Overall the aggregate sales and the number of plans sold of the pre-need industry declined by almost 48% and 61% respectively for that same period.

The collapse of the pre-need industry began when PNCs offering educational plans—namely, College Assurance Plan (CAP), Pacific Plan, Inc. (PPI), followed by PET Plans, Platinum Plans and TPG Corporation—defaulted on their obligations leaving the planholders, whose educational plans have already matured, empty-handed.

A closer look at the sales of the pre-need industry by plan, reveals a disturbing reality—that is, declining sales have not been limited to the educational plan companies. The sales of the entire pre-need industry started to dip in 2002, registering 2% drop and another 14% the following year. It momentarily recovered in 2004 by registering growth of 13%. However, this was not sustained. In 2005, sales nosedived, almost 45%, and dipped further by 4% in 2006 (*Figure 1*). Industry insiders see the continuous deterioration of the pre-need industry.

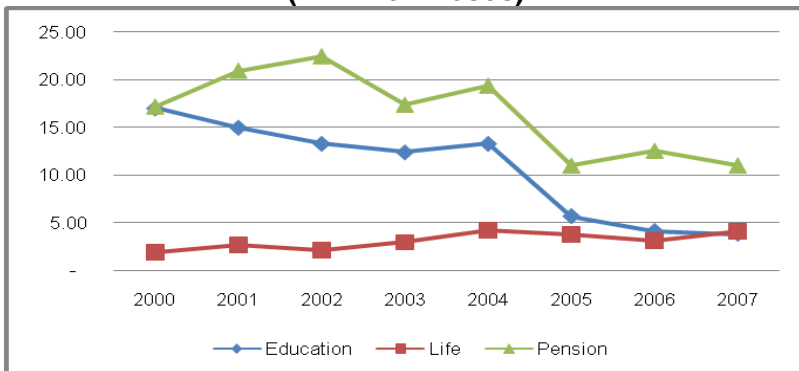
**Figure 1**  
**Combined Sales of Pre-Need Companies, 1994-2007**



Source: Securities and Exchange Commission

The problem hounding the educational plan companies has spread over the entire pre-need industry (*Figure 2*). De Ocampo (2005) noted that the persisting difficulties with the pre-need industry could “threaten the viability of the whole insurance and financial sector, and even the educational sector.”

**Figure 2**  
**Pre-Need Sales, By Plans**  
**(In Billion Pesos)**



Source: Securities and Exchange Commission

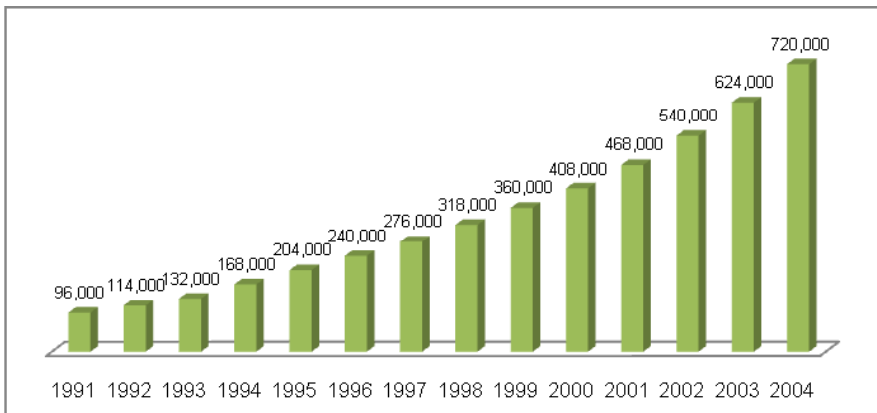
## WHY THE COLLAPSE?

The declining sales are the result of the erosion of public confidence in the pre-need industry, because of the inability of the pre-need educational companies to fulfill their commitments to customers. Moreover, the decision of the SEC to stop these problematic companies from selling pre-need plans to protect planholders had ripple effect on other PNC's. It effectively dragged the entire industry down.

The main reasons (that have been cited by various sources such as, the academe, the pre-need industry, the planholder's etc.) as contributing to the ills of the pre-need industry are the following:

### A. The deregulation of tuition fees in 1992 led to the skyrocketing of such fees.

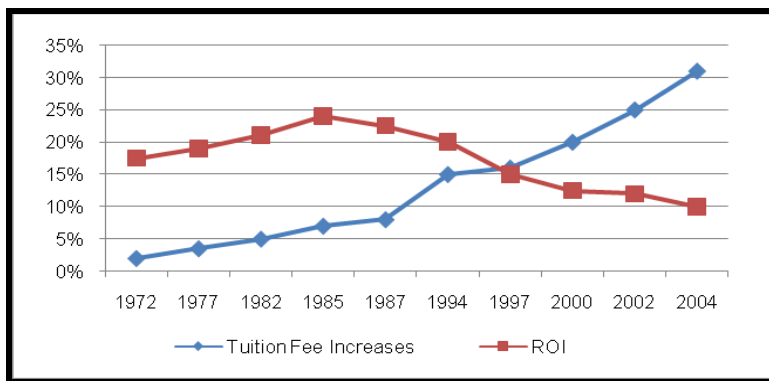
**Figure 3**  
**Cost of 4-Year College Education**  
**(after deregulation of tuition fees)**



Source: Philippines Federation of Pre-Need Plan Companies, Inc.

A study conducted by the Philippine Federation of Pre-need Plan Companies, Inc. (PFPPCI) showed that after deregulation, tuition fees started to increase at an average of 17% annually (*Figure 2*). According to the study the cost of a 4 yr traditional (open- ended) educational plan increased 12 times from P20,000 to P240,000 after ten years.

**Figure 4**  
**Rate of ROI vs. Tuition Fee Increases**



Source: Philippines Federation of Pre-Need Plan Companies, Inc.

The deregulation of tuition fees exacted a heavy toll on the finances of pre-need companies. Prior to 1992, pre-need companies enjoyed significant gaps between tuition fees and ROI. The gap started to narrow after the deregulation in 1992. Tuition fee and ROI began to equalize by 1997. By 2004 the gap had widen causing a variance of almost 20% (*Figure 4*).

The adverse impact of the deregulation of tuition fees took 10 year to fully materialize as trust funds and sales could no longer cover the mounting obligations.

## **B. Lower interest yields on Trust fund investments and the Asian financial crisis of 1997 and its lingering effects.**

The Asian financial crisis broke out in 1997 causing a slowdown in the economy of countries in the Asian region including the Philippines. The stock market crashed and wrecked the trust fund investments of the pre-need companies.

## **C. Inadequate or Weak Regulation**

The SEC is partly to blame for the collapse of the PNCs. As a regulatory body, the SEC could have pre-empted some of the problems, such as the defects in the traditional or open-ended educational plans, the inappropriate accounting practices and the possible collusion between the trustee banks and the PNCs. However, the SEC intervened too late.

## **D. Inappropriate Accounting Practice**

According to the SEC, the entire pre-need industry used aggressive accounting practices which understated liabilities and tended to present a rosier financial picture than warranted. As a corrective measure the SEC in 2002 imposed the use of the Pre-Need Uniform Chart of Accounts (PNUCA) as a standard for reporting of finances and liabilities. With the PNUCA in place, pre-need educational and pension plans were no longer treated as investment contracts but as insurance contracts, subject to the Actuarial Reserve Liability (ARL) scheme.

In addition the SEC imposed circulars instituting ARL as method of valuation for pre-need industry. Circular # 6 sets the standard for valuation of the ARL for pre-need plans, Circular # 7 requires

pre-need companies to provide information relevant to actuarial valuation report and Circular # 8 sets the responsibilities of actuaries in the pre-need actuarial reserve valuation. These, according to the PFPPCI have caused major difficulties to their members.

These changes in accounting methods further weakened the financial statements of the pre-need companies, and effectively constrained their investment activities.

#### **E. Collusion among pre-need companies and their affiliates.**

Collusion between pre-need companies and their affiliates could result in possible diversion of the trust fund into business ventures other than the intended investment specified by the SEC.

In 2005, Senator Serge Osmena, during committee hearings, mentioned about CAP and PPI impropriety in handling their trust fund. Specifically, he pointed to the questionable investment of CAP in its affiliates company such as the Fil-Estate Management, Inc (FEMA) and PPI appointment of Rizal commercial Banking Corporation (RCBC) as its trustee bank. Likewise, Atty. Maricel Lopez, counsel for CAP planholders accused CAP's executives of diverting P25 billion of its trust funds to its affiliated corporations (Camp John Hay Development Corporation, Metro Railway Transit and Fil-Estate Company)

As a result, CAP had incurred P1 billion loss in bad investment in FEMA alone, a holding company of the Sobrepeña family, which also controls CAP. Moreover, CAP engaged the trust fund in a

wrong mix of investments from related parties at questionable prices. On the other hand, PPI and its trustee bank, RCBC, both owned by the Yuchengco Group of Companies (YGC), have interlocking officers. While PPI is in financial distress, the YGC has earned a whopping 1055% ROI on its P165 million investment in just 8 years.

## **F. Corporate indiscretion**

The open-ended plan or traditional educational plan exposes pre-need firms to higher obligations under a deregulated tuition fee regime. To cover their ballooning obligations, pre-need educational companies operated much more like a pyramid scam. With the dissipation of the trust fund requirement (due to payment of matured plans), the company had to sell more and more new plans to pay already matured and maturing plans. As a result new planholders could no longer benefit from their investment.

## **RECOMMENDATIONS**

Various stakeholders and advocates have forwarded proposals to address the ills plaguing the pre-need industry and mitigate the continuing fall-out from the crisis, if not avert a full-blown collapse of the pre-need industry.

### **Reform within the Pre-need Industry**

- Conduct rigorous independent audit to determine which PNCs remain viable, which have the financial capabilities to remain in the business. Licenses of those that fail in the audit should

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be revoked by the SEC and placed under administrator or receivership.

- Create a “Holding Company” (HoldCo) which is owned by existing PNCs shareholders and planholders, through a consensus agreement among the SEC, Pre-need Companies and planholders. Pre-need plan companies will be converted into a new corporation acting as a holding company. Planholders’ educational plans will be converted into shares of stocks making them as co-owner of the newly created holding company.

The rationale behind this scheme is to rehabilitate bankrupt pre-need educational firms and making planholders co-owner by converting their educational plan into equity of the newly formed company.

- Promote tripartite agreement among planholders, PNCs and SEC to:
  1. Restate and reduce the Maturity Values of Traditional Educational Plans to reflect realistic investment return assumptions or convert open-ended plans to fixed value plans.
  2. Convert the difference between the original and revised Maturity Values into equity in HoldCo and require the shareholders of distressed PNCs to subscribe to additional capital in HoldCo – as a condition for staying in business.

3. Institute fundamental changes in the corporate governance of the surviving PNCs involving, among others; financial and operational transparency, and management accountability.

### **Legislative Measures**

- Establish a Pre-Need Plan Code to serve as a legal framework that will oversee and regulate the industry. The lack of statute that governs the pre-need industry calls for the creation of such Code. The salient features of the Code should include among others:
  - A stricter and closer regulation and examination of pre-need companies.
  - Establish a pre-need planholder's protection fund similar to that of the Philippine Deposit Insurance Commission (PDIC).
  - Code of ethics for pre-need companies directors and officers.
  - Stricter licensure and registration to ensure that only qualified pre-need companies will engage in the business.
  - Stronger penalties for offenses such as infidelity in handling trust fund (DOSRI loans and investment, self-dealing among affiliate firm etc.).
  - Prohibiting the engagement of affiliate banks as trustee.

- Defining the grounds for suspension and revocation of licenses.
  - Increase trust fund requirement from 51% of pre-need collection to 60%.
  - Periodic assessment of ARL to insure that pre-need firms could meet its future obligation.
- Transfer the supervision of the pre-need industry to the Insurance Commission.

SEC is part of the reason for the collapse of the pre-need companies because of weak regulation and the lack of foresight. With the PNUCA in place it defines the very nature of the pre-need plan as insurance not as an investment instrument. The Insurance Commission has the capabilities and the expertise in regulating this kind of industry, for these reasons regulation and supervision should be handed to the Insurance Commission.

- Promote and develop a secondary market for pre-need plans.

A secondary market is a market on which an investor purchases an asset from another investor rather than an issuing corporation. The existence of a secondary market for pre-need plans can further enhance their value to planholders, and their overall attractiveness as a savings and investment instrument.

## CONCLUSION

The pre-need industry can contribute significantly to socioeconomic development in the Philippines. Pre-need plans have proven to be a popular mode of savings for many Filipino families of modest means. It has also been demonstrated that the pre-need industry is capable of mobilizing significant amount of long-term savings to serve the financing requirements of both private and public investments. Pre-need plans can also alleviate the demand for government social services from the Philippines' growing population.

The growth of the pre-need industry strongly depends on trust and confidence. The Philippine experience shows that excesses and failure of one or two pre-need companies can have serious repercussions on the whole industry. In this regard, the institutionalization of sound rules, and regulatory and supervisory structures that will govern the activities of pre-need companies and assure the stability of the industry, and at the same time protect present and future plan-holders, cannot be overemphasized.

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## Notes