

## **Discussion on Principles of a Mandatory Second Pension Pillar**

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**Supplementary Paper No 03**

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## Table of Contents

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Table of Contents .....	i
List of Tables .....	ii
01. Characteristics of a Mandatory Second Pension Fund.....	1
02. Access to Pension Plans, Vesting Rights and Disclosure of Information, .....	2
03. Designing the Pay-Out Phase of Private Pensions.....	3
04. Save-guarding the Pension Funds.....	7

## List of Tables

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**Table 01:** Forms of Pay-Out Options of Private Pensions

## 01. Characteristics of a Mandatory Second Pension Fund

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The establishment of a Mandatory Second Pension Fund would be within the regulatory parameters established in the appropriate legislation by the competent regulatory body – that is the Malta Financial Services Authority (MFSA).

The 2010 Pensions Working Group (PWG2010) proposes that the appropriate legislative instrument should provide for an Autonomous Pension Fund (APF) which would be regulated under conditions that stipulate that APFs:

- are independent legal entities that are different from insurance undertakings and other financial institutions, forming a pool of assets bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits.
- are segregated from the employer or the asset of the member or service provider so that the employer or the service provider cannot get at the funds and that the funds cannot be used for any other purpose.
- members have a legal or beneficial right or some other contractual claim against the assets of the pension fund.
- can take the form of either a special purpose entity with legal personality and capacity administered by an internal governing body or a legally separated fund without legal personality and capacity administered by an external governing entity such as a pension fund manager.

Further to the above, the PWG2010 is also of the considered opinion that a Mandatory Second Pension can also be established under the Insurance Business Act (IBA).

It so follows that it would be up to an individual employer to determine, within the appropriate legislative framework, the type of Mandatory Second Pension it seeks to constitute.

It is to be noted that the Special Funds (Regulation) Act, as currently designed, does not account for the setting up of an Occupational Retirement Pension (ORP) as a Non-Autonomous Pension Fund (NPF) – which consists of either (a) reserves and assets that are not legally separated from the plan sponsor or administrator (such as for example book reserve systems); or (b) other pension plan assets over which the plan sponsor has legal ownership.

The PWG2010 are of the considered opinion that the Special Funds (Regulation) Act should **not** be amended to allow for the setting up of ORP schemes as a NPF.

The PWG2010 PWG2010 is of the considered opinion that the MFSA should not limit the choice of pension instruments – whether under the Special Funds (Regulation) Act or the Insurance Business Act.

Nevertheless, the PWG2010 PWG2010 believes that employees and their representatives as well as employers, when embarking on introducing a Mandatory Second Pension, should be cautious in deciding that such a Pension should be based on a Defined Benefit (DB) scheme.

DB schemes, whilst ensuring that the value of the pension received upon retirement is pre-determined, such a pre-determination may place considerable financial strains on the employer in the event that the liabilities of the scheme exceed its assets. Given that the risk of a DB scheme is placed entirely with the employer a situation of under-funding may arise that could threaten the viability of the employer; and consequently the employment of the persons working with him or her.

The PWG2010 is of the considered opinion that the relevant Special Funds (Regulation) Act and Insurance Business Act respectively should not restrict the type of pension instruments upon which a Mandatory Second Pension is designed it cautions that employers and employees should be fully recognisant of the resulting limitations that a Defined Benefit Scheme may have on the employer prior to a decision of adopting such a scheme.

## **02. Access to Pension Plans, Vesting Rights and Disclosure of Information,**

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In the design of pension plan products, with regards to a mandatory ORP framework it is imperative that there is no discriminatory access directed to exclude from persons from plan participation on the basis of non economic criteria such as age, gender and marital status for non-insurance based pensions and gender for insurance based pensions.

It is pertinent to note that the guidelines issued by the National Commission for the Promotion of Equality exclude from its scope occupational pensions. It is recognised that the Commission is currently discussing discrimination arising from 'age' and this is expected to be established as a criteria in the forthcoming future.

The PWG2010 suggests that the National Commission for the Promotion of Equality should ensure that no discriminatory access is introduced by private pension providers directed to exclude persons from plan participation on the basis of non economic criteria such as age, gender and marital status in the case of non-insurance based pension instruments and gender (subsequently age when introduced) in the case of insurance based pensions.

Furthermore, the PWG2010 underlines the importance that the Department of Industrial and Employee Relations ensures that the appropriate level of protection to employees from retaliatory actions and threats of retaliation either by the employer or pension plan representative with respect to pension benefits and the exercising of rights under a pension plan is in place. Examples stated by OECD<sup>1</sup> include:

- the protection of employees from termination of employment carried out with the intent to prevent the vesting of an accrued benefit under the pension plan.
- the protection of employees exercising their rights under a pension plan such as filing of a claim or appeal or the initiation of administrative or judicial action from termination of employment, suspension, discipline, fine or any other type of discrimination.

The PWG2010 agrees with the policy guidelines relating to benefit accrual and vesting rights as articulated in the Implementing Guideline for Core Principle 5 of the OECD: the rights of members and beneficiaries and adequacy of benefits. The key guidelines of note are the following:

- the protection of benefits that an employee accrues in an OPR scheme, the prevention of the retroactive reduction of the value of benefits previously accrued in the scheme and the provision to the participants within an OPR scheme with timely notice regarding any reduction in the rate of future benefit accruals in the scheme.
- the immediate vesting of accrued vesting, or the vesting after a period of employment with the employer contributing to the OPR scheme that is reasonable in light of average employee tenure.
- the immediate vesting of benefits derived from employee contributions to the OPR scheme.

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<sup>1</sup> Pg 19, Private Pensions and Policy Responses to the Crisis – Recommendation on Core Principles of Occupational Pension Regulation, OECD, June 2009

- the protection of vested benefits of those employees who would have severed their employment with their employer and, therefore, should not be subject to forfeiture, regardless of the reasons of termination except in limited cases of dismissal resulting from acts of gross malfeasance which should be clearly defined.
- the protection of vested benefits when the employer or the pension service provider changes ownership due to merger, acquisition, or files for bankruptcy as well as from creditors of individual plan members.

Similar to the previous recommendation, the PWG2010 suggests that the Department of Industrial and Employee Relations should take the appropriate measures to ensure that such safeguards are in place.

With regards to the portability rights of pension plan holders the PWG2010 suggests that:

- a pension plan holder who decides to shift a pension plan policy from one pension service provider to a different pension plan provider should be protected from the charging of unreasonable exit fees by pension plan providers.
- an employee who changes job should be able, upon request, to move the value of the vested account benefit in a Defined Contribution (DC) pension from their former employer's pension plan either to the plan of their new employer or to an alternative financial instrument or institution; and in doing so should not be inhibited by prohibitive and unreasonable exit fees.
- an employee should hold a portability right of his or her vested account benefit when he or she separates with an employer – whatever the reason for such termination.
- an employee should not be obliged to exercise his or her portability right when he or she terminates employment and thus should hold the right to choose to retain his or her vested account benefit with his or her previous employer.

Further to the above, the regulatory framework should be reviewed to ensure that the optimum disclosure requirements are strengthened in order to help individuals make efficient choices.

Slovakia, for example, following the economic crisis, has strengthened legislation to demand that pension fund management entities provide more detailed information about participants' rights, fund management and results. The Hungarian Financial Services Authority has introduced a new communications strategy emphasising the importance of the disclosure of 10 year performance records including an explanation of weak returns. The UK has significantly increased communications activity via a series of public statements to employers and trustees setting out their general position in relation to current market conditions.<sup>2</sup>

The PWG2010 suggests that the appropriate regulatory frameworks in the Special Funds (Regulation) Act and in the Insurance Business Act should be reviewed to ensure that they provide the optimum disclosure requirement on pension service providers in order to help individuals and employers make efficient choices and decisions.

### **03. Designing the Pay-Out Phase of Private Pensions**

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This Supplementary Paper proposes that the pension benefit on retirement should be taken in a small part as a lump sum on retirement and the majority of the saving would be used for the purchase of an annuity or income generating schemes.

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<sup>2</sup> Pg 16, Ibid

This section seeks to put forward the rationale behind these recommendations. In essence there are four main options available for the pay-out phase of a private pension scheme as shown in the table hereunder:

**Table 01: Forms of Pay-Out Options of Private Pensions**

	Provide Protection Against		
	Flexibility Liquidity	Longevity Risk	Bequest
Lump-sum	Yes	No	Yes
Programmed withdrawal	Yes	No	Yes
Life annuities	No	Yes	No
Combination arrangements	As appropriate	As appropriate	As appropriate

These forms of pay-out options are discussed below:

**(a) Lump Sum Payments**

This policy approach allows a person to withdraw the entire value of the accumulated retirement capital as a lump sum. Such payment would normally occur upon retirement – although a delayed payment, whilst still maintaining its role as a retirement income, is also possible.

Schemes can be designed to allow for advanced payments – that is, payments before retirement. In such instances the retirement focus of the saving arrangements can be diluted. Some countries allow full or partial premature withdrawals in a variety of circumstances such as house purchase, serious disability, etc. Countries that allow for partial pre-retirement withdrawals include Mexico (10% only on marriage and unemployment); Switzerland (house purchase); and Singapore (death, disability, housing, education).<sup>3</sup>

An advantage of lump sum payments is that these are easy to administer as they do not require complex longevity calculations. The receipt of a lump sum payment on retirement whilst having a short-term economic impact given that it increases the retiree's liquidity on retirement, may lead to long term dangers in the event that retirees do not self-annuitise this income for retirement purposes. This danger is real. For example, in Australia, in 2000 at least 90% of the plan benefits of private sector members were taken as lump sums – with only less than 10% annuitising their income for retirement purposes.

The application of the principle of self annuitising, which is claimed by some to be a strength of the lump sum option, where a retiree may on his or her own initiative seek where to finance the income is not, at least in the opinion of the PWG2010, an advantage. Self-annuitising is not a simple process and most people, as discussed in the main Report, are not well equipped to deal with complex long term financial plans.

This option concerns the PWG2010 in that empirical evidence exists that individuals are likely to spend the money in an accelerated manner – and in doing so exhausting their retirement funds within a short period. Thus, they will fail to secure the financial income for the long term to ensure that their quality of life during retirement is as close as possible to that enjoyed whilst they were in employment.

<sup>3</sup> Pg 6, Antolin P., Pugh C., and Stewart F., Forms of Benefit Payment at Retirement, OECD Working Papers on Insurance and Private Pensions No.26, OECD Publishing, 2008

## **(b) Programmed Withdrawals**

Programmed withdrawals consist of a series of fixed or variable payments whereby the annuitant draws down a part of the accumulated capital (and continued earnings there on). The key word is 'programmed' – thus implying more discipline than the less structured erosion of a lump sum withdrawal. Programmed withdrawals do not involve longevity guarantees that would require complex actuarial reserving and solvency margins. They are financially uncomplicated. There is no cross-subsidy from those who live for only a short time in retirement to those who live longer than the expected average. Programmed withdrawals also address the basic bequest motive.<sup>4</sup>

Programmed withdrawals attempt to produce relatively stable annual income for the lifetime of the retiree. Programmed withdrawals involve dividing the retirement capital by a clearly defined factor. The most common denominators are:

- (a) Present value of a life annuity – where the retirement capital is divided by an equivalent life annuity. Calculations may be performed only once and thus the pension payments will be constant or the calculation may be repeated every year which results in a constant re-spreading of the remaining, declining capital.
- (b) Life expectancy – where the retirement capital is divided by the expected future life expectancy of the annuitant. Here too practice differs as to whether the calculation is made only once at the beginning or annually throughout the individual's lifetime.
- (c) Annuity certain to an advanced age – where an advanced age beyond the average life expectancy (Canada for example allows an annuity certain to age 90) is taken for calculation purposes in order to avoid frequent depletion of the retirement capital.<sup>5</sup>

There are many variants within this theme – which include:

Totally Prescriptive Formula.

Both Minimum and Maximum Limits.

Only Minimum Payment Requirements.

Annuity Certain.

Programmed withdrawals are more constraining compared to lump sum payments though less constraining than purchasing a life annuity. Moreover, in a similar manner to lump sum payments, programmed withdrawals satisfy the 'bequest' motive', whereby any balance remaining at the retiree's death is payable to the individual's estate. Furthermore, the capital of programmed withdrawals schemes continues to be invested in the pension fund and thus continues to earn a rate of return.<sup>6</sup>

Yet, in a programmed withdrawal scheme the risk exists that the capital will be exhausted whilst the retiree is still alive given that the amount and duration of programmed withdrawals are generally calculated on the basis of 'average' life expectancies. A retiree can, therefore, outlive these averages. A complicated feature of programmed withdrawals is that, under some forms, whilst the monthly payment at the beginning of the scheme is generally higher than under a conventional life annuity, the monthly payments can be very much lower in later years.

It is pertinent to note that whilst programmed withdrawals are present in a considerable number of jurisdictions, the UK is very cautious in its advice to individuals regarding such arrangements – making a strong case for a person to choose a traditional life annuity and present programmed withdrawal products being viewed as being suitable only for well-off individuals with considerable amounts of retirement capital.<sup>7</sup>

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<sup>4</sup> Pg 8, Ibid

<sup>5</sup> Pg 9, Ibid

<sup>6</sup> Pg 11, Ibid

<sup>7</sup> Pg 12, Ibid



### (c) Life Annuities

Under the traditional and most commonly found annuity approach, the person's contribution accumulation (and profits earned) is transferred at retirement to a life insurance company. In turn, the insurance company provides an annuity that, in its simplest (single life) annuity form, will make payments to the retiree for the rest of his or her life. These payments are made on a regular basis – even weekly. The retiree is generally allowed to choose the most competitive and appropriate insurance company to which his or her personal pension account is transferred.

The main advantage of life annuities is that the payments are fixed and are made for the entire lifetime of the retiree. The payments in the first year are the same under a life annuity and under a programmed withdrawals based on the present value of a life annuity. During the ensuing years, however, retirement payment from programmed withdrawals, as explained earlier, slowly declines in comparison to life annuities. With regards to programmed withdrawals using life expectancy as the denominator, retirement payments actually increase over time – though they never reach the levels of a life annuity.<sup>8</sup>

It is pertinent to note that life annuities involve the retiree foregoing future control over investments and losing the potential to earn superior investment returns. It also runs counter to the bequest motive – and thus provides for no protection to the retiree's spouse, partner or other dependents after his or her death. Moreover, under the conventional single life annuity the pension payments stop immediately upon the retiree's death.

Thus, if the retiree is unfortunate enough to live for a very short period after his retirement the expenditure of a large amount of capital on the purchase of an annuity will, undoubtedly, be perceived as an extremely poor investment. Under a single life annuity the retiree's entire accumulated retirement capital is transferred to an insurance company that invests the money for the aggregate support of its entire portfolio of annuity business, and not for the individual account of the pensioner. One other limitation of the single life annuity is that it does not provide protection against inflation<sup>9</sup>.

The market for annuities has developed more complex life annuity products in an attempt to address some of concerns discussed above - which include:

Escalating Life Annuities.

Variable Annuities.

Deferred Annuities and Longevity Insurance.

Joint and Survivor Annuity.

Contingent Annuity.

Full Cash Refund Annuity.

Modified Refund Annuity.

Life Annuity with N Year Guarantee.

Modified Refund Annuity.

It should be noted in most advanced societies insurance companies are the sole providers of life annuities. OECD states, however, that the number of insurance companies interested in selling annuities has fallen dramatically in recent years in “some markets that would normally be categorised as mature and well developed” – a primary reason being because life annuity business can be particularly uninteresting or even unprofitable (low investment returns and increasing longevity, coupled with high reserving requirements).<sup>10</sup>

<sup>8</sup> Pg 13, Ibid

<sup>9</sup> Pg 14, Ibid

<sup>10</sup> Pg 26, Ibid

#### **(d) Combined Arrangements**

Combined arrangements constitute a mix of two or more pension payout methods upon retirement. For example, Germany (Reister pensions only), Ireland, Italy, Portugal, South Africa and the UK allow for partial lump sums plus life annuities. Canada provides for programmed withdrawals followed by mandatory annuitisation.

The PWG2010 is of the considered opinion that the pension benefits stemming from the a Mandatory Second Pension should be on the basis of a combination arrangement that incorporates a lump sum withdrawal and a purchase of an income generating option. The PWG2010 suggests that the combination arrangement should be biased towards the mandatory purchase of an annuity or pension income. A potential combination could reflect the following:

- the flexibility to withdraw up to a maximum of 25% of the accumulated capital (including pro-rated earnings) as a lump sum.
- the mandatory purchase of annuity or pension income generating option with the remaining 75% of the accumulated capital (including pro-rated earnings) where the retiree would be provided with the opportunity to select the insurance company from whom he or she will purchase the income generating option.

The PWG2010 is of the considered opinion that an investor in a Mandatory Second Pension should be provided with the opportunity to invest over and above the minimum requirements established for a Mandatory Second Pension should he or she wish to 'top-up' to include coverage for request, invalidity, et al.

#### **04. Save-guarding the Pension Funds**

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One consequence of the economic and financial turmoil and its resultant impact on the pension funds is that it brings to the fore the issue of whether pensions funds should be protected, and if so, what should the protection cover, and to what extent should it provide protection.

It is to be noted that different jurisdictions have assumed different approaches to provide Pension Fund Protection Schemes (PFPS). The Netherlands, for example, seeks to achieve security and protection via strong funding rules. The UK, on other hand, seeks to achieve such security through pension benefit guarantee schemes – namely the Pension Protection Fund.

Traditionally, PFPS are a form of insurance arrangement – with premiums paid by pension funds – which take on outstanding pension obligations of both active and retired employees which cannot be met by the insolvent plan sponsors. Moreover, a PFPS can also provide a layer of security for the beneficiaries in an ORP in the event that the employer becomes bankrupt.

It is to be noted, however, that arguments exist against the setting up of PFPS. One key argument is that a PFPS creates a 'moral hazard' – in that, if an employer knows that upon bankruptcy their defined benefit pension fund liabilities will be covered, even if sufficient assets are not available to back this promise, the employer could be incentivised to indulge in irresponsible behaviour, leaving others to cover the costs of the pension promises they would have made or agreed to as a result of collective bargaining with the Unions. Responses to this risk include the placement of a limitation on the pension benefit covered such as the Ontario fund, or through the imposition of strict funding rules in order to limit the size of the potential claim made on the PFPS.<sup>11</sup>

The second argument against the setting up of a PFPS is what is termed as 'adverse selection' – in that if when the premium rate is set due consideration is not taken of the contributing firm's bankruptcy risk, pension funding level and investment policy, stronger member firms will inevitably end up subsidising weaker ones as a PFPS will provide protection to members of a DB scheme in the

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<sup>11</sup> Pg 6, Stewart, F., Benefit Security Pension Fund Guarantee Schemes., OECD Working Papers on Insurance and Private Pensions, No 5, OECD Publishing, 2007

event that the employer is rendered bankrupt. If these cross subsidies are too high, the problem of 'adverse selection' kicks in as financially secure firms find ways of pulling out of a guaranteed system – with employers, for example, withdrawing from providing DB schemes and replacing them by DC schemes<sup>12</sup>.

There is one important function that PFPS do not do: they do not provide protection against the market risk in defined contribution schemes. Thus, the reduction in the value of pensions fund will not be compensated, in part or in full, by a PFPS.

It is pertinent to note that the White Paper, Pensions: Adequate and Sustainable, had argued that a Second Pension framework should be supported by measures that are to be introduced to protect the beneficiaries vis-à-vis their contributions in the event that firms become insolvent as well as in circumstances of fraud and misappropriation. The Final Report by the PWG had re-affirmed this recommendation.

In this regard the PWG2010 recommends that appropriate levels of protection against bankruptcy or malfeasance, whether these are in the form of robust funding rules, or asset liability matching or priority insolvency rights or the constitution of a Pension Protection Fund should be introduced.

The PWG2010 thus suggests that the Committee recommended in the Report to review the setting up of a Mandatory Second Pensions should be assigned as a term of reference the study protection regime options that could be introduced to safeguard pension contributors against insolvency, misappropriation and malfeasance.

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<sup>12</sup> Pg 6, Ibid