Investment Principles for Occupational Retirement Schemes

Supplementary Paper to the Final Report of the Pensions Working Group

Supplementary Paper Number: 06

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Date: 30th June 2005

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Executive Summary

The Paper aims to discuss the two main questions raised during the Consultation exercise carried out in connection with the White Paper regarding the Pension Reform in Malta, in the area of Investment Process of Second Pillar Pension Schemes ("SPPSs"). The main questions arising are:

a. To what extent should pension funds' investments be limited and what type of investment guidelines should be imposed?
b. To what extent should SPPSs be utilised to aid the development of the local securities/capital market?

The manner in which assets of a pension fund are invested is relevant for retirement income (and hence for maximisation of returns and security of assets) and the development of capital markets.

In turn, the way in which the investment management process is regulated and supervised (i.e. the framework within which pension funds carry out their investment management activity), has a direct and fundamental bearing on these three aspects.

There are two main approaches to the regulation of the investment management process – the Prudent Man Rule and the Quantitative Approach. The adoption of either approach has been the subject to extensive debate within regulatory circles across the OECD[1] and the European Union ("EU").

The Prudent Man Rule avoids the imposition of stringent portfolio limits and focuses on regulating the behaviour of investment managers. Very often this Rule is complemented by the Principles of Care, Loyalty, Prudence and Diversification. On the other hand the Quantitative Approach prescribes various investment limits which investment managers are obliged to follow in their portfolio allocation on behalf of pension funds.

Both approaches have advantages and disadvantages – relevant from the perspective of security of the pension fund assets and the optimisation of investment performance. In this regard, international studies suggest that:

a. the Prudent Man Rule is best placed to the optimisation of investment performance by the assets of pension funds;
b. in so far as security of assets is concerned, the Prudent Man Rule, when coupled with the duty of care, diversification, prudence and loyalty has curbed any adventurous activity by investment managers.

Quantitative investment restrictions appear to have direct impact on the development of local capital markets – through the imposition of investment restrictions which obligate a SPPS to channel funds in particular markets or particular asset categories. However such an approach needs to be viewed within the contexts of the specific capital market – since the benefits of capital market development may not necessarily materialise in the fashion envisaged theoretically, particularly in small and narrow capital markets where certain type of quantitative restrictions may have negative repercussions.

According to data as at December 2001, the approach varies between OECD countries – although findings suggest that:

a. The imposition of quantitative restrictions is generally aimed to ensure diversification and prohibit self-investment.
b. The position regarding limitation of equity investments is split.
c. No country imposes ceilings on investments in government bonds, with only two countries impose floors in this regard.
d. Limits on investment in domestic assets are not wide-spread.

[1] Organisation for Economic Co-Operation and Development

e. Various countries impose direct or indirect limits on international investment, also differentiating between OECD and non OECD countries and EU countries.

While according to international surveys, in the Anglo-Saxon countries, pension funds are generally required to follow “prudent man rules”, no emerging market is allowed to follow the prudent man rule. This difference in approach may be due to the context prevalent within respective countries – where emerging markets, compared to developed countries - usually have to contend with underdeveloped capital markets, limited foreign exchange reserves and poor regulatory foundations.

The regulatory approach in certain countries appears to be influenced by whether a pension fund is voluntary or mandatory. This is due to the fact that in a mandatory environment, the Government assumes a higher degree of responsibility and hence there is a ‘stronger’ case for a more stringent regulatory approach than for voluntary pension funds.

The OECD and the INPRS2, as well as the EU in so far as SPPSs covered by Directive 2003/41 EEC are concerned, recommend the application of the prudent man principle and the avoidance of quantitative restrictions, unless justified on a prudential basis. In so far as capital controls are concerned, all entities recommend that no capital restrictions are imposed. Moreover, the imposition of capital controls can go against the freedom of capital requirements in terms of the EU Directive on Capital Flows.

Hewitt Associates (“the Actuaries”), the company which carried out the Actuarial Impact Assessment in connection with the White Paper on the Pension Reform in Malta, also recommend the adoption of the prudent man rule supported by diversification rules and limitations focused solely on marketable instruments and regulating the use of derivatives, prohibitions of self-investments and limiting investments in local properties. The Actuaries made these recommendations also taking into account the local context, and the current stage of development of the local capital market.

The Local Capital Market is characterised by lack of a variety of investment instruments, low trading and is small. The prudent man approach appears to be more suitable given the inherent characteristics of the local capital market. However other aspects need to be taken into account, including whether SPPSs are to be mandatory or voluntary, which EU Directive will be applicable as well as other special risks that may be prevalent such as equity, property and high risk capital market investments.

Conclusions

SPPSs could possibly play a significant role in the development of the local capital market. However, the development of the local capital market is not dependent solely on SPPSs and SPPSs should not be utilised as a primary tool to develop the local capital market – particularly given the small and narrow nature of the local capital markets and the respective associated risks.

The response of the local capital market to a potentially increased demand for securities remains uncertain. An increase in assets for investment through the introduction of SPPSs could create an imbalance between the demand and supply of local market securities, - (depending on many factors) - could potentially cause significant distortions, concentration of risk exposures and asset price bubbles.

Moreover, given the characteristics of the local securities market, including lack of investment instruments, and the concentration risks associated with such restrictions, the SPPS may find itself in a situation of not being able to achieve investment returns otherwise attainable through investments in other markets.

Even when the development of local markets is an important policy objective, SPPSs should not be used for this aim to the detriment of sub-optimising the performance of pension funds and the resultant lack of adequacy of retirement benefits. The primary aim of SPPS should be and should remain that of providing the highest level of retirement benefits in a secure manner.

[2] International Network of Pensions Regulators and Supervisors

It is acknowledged that allowing SPPSs to invest outside of Malta, leads to capital outflows with their associated macroeconomic implications. However no capital controls are imposed on other institutional investors – such as collective investment schemes and life assurance companies. Moreover, the imposition of capital restrictions may go against EU requirements and Malta's liberalisation policy that has been implemented gradually over the past years.

It is concluded that local SPPSs should be allowed to follow the prudent man principle. In line with modern portfolio management techniques and the investment principles applied internationally and also at EU level for voluntary occupational pension schemes, the investment allocation of assets should be left in the hands of competent investment managers who should be provided with sufficient discretion as to where and how to allocate assets in the best interests of scheme members and beneficiaries and in a manner which is efficient and secure.

However this prudent man approach should be supplemented with a strong regulatory framework based on the principles of care, diversification, prudence and loyalty. The regulatory framework should establish a strong governance operational framework for SPPS. In addition, it is considered that the prudent man rule should be supported by certain quantitative restrictions aimed primarily at ensuring diversification and addressing particular risks such as prohibiting direct investments in immoveable property. In addition, at the crucial initial stages of introducing SPPSs within the local market, there is scope – from a social policy perspective - of imposing maximum investment limits on investments in equities and high risk capital markets – in order to address the special risks associated with these type of investments for the protection of citizens in Malta.

The Special Funds (Regulations) Act, 2002 already provides a suitable framework which can be utilised for the introduction of local SPPSs, subject of course to certain amendments to cater for specific issues associated with the local scenario.

Moreover, the pension structure adopted i.e. whether mandatory or voluntary, may influence the regulatory response in this areas, in so far as investment regulation is concerned in terms of the EU Pensions Directive.

Recommendations

Local SPPSs should be required to manage assets under their management in line with the prudent man rule, supported with quantitative restrictions aimed primarily to ensure diversification, limiting exposure in particular issuers and particular companies. However, the investment allocation of the portfolio between industries and specific countries should be left in the discretion of the competent investment manager, who should be required to record fully the rationale of any investment made.

Local SPPSs should also be subject to quantitative restrictions aimed at addressing special and specific risks, as follows:

§ Investments in employer-related assets should be limited to 5% of assets under the management of the SPPS.
§ Granting of loans should be prohibited.
§ Investment in direct property should not be allowed. Rather local SPPSs should be allowed to gain exposure to the property market through investment in equities / bonds issued by companies involved in the property market.
§ Investments in unlisted securities should be limited to 10% of net assets under the management of the SPPSs.

Moreover, at the crucial initial stages of introducing SPPSs within the local market, there is scope – from a social policy perspective - of imposing maximum investment limits on investments in equities and high risk capital markets – in order to address the special risks associated with these type of investments for the protection of citizens in Malta. In this regard, it is recommended that:

§ Investment in equities should be subject to a maximum limit of 35% of net assets under management.

- Investment in high risk capital markets (which may be defined as including non-OECD countries, provided that investments in Malta are permissible) should be subject to a maximum limit of 30% of net assets under management.
- These restrictions should be reviewed within 5 years' time. Moreover, it is also recommended that these restrictions are not imposed on the underlying funds in the case a SPPS invests through a Retirement Fund which is a fund of fund, as long as the underlying funds have a demonstrated track record to the satisfaction of the Regulatory Authority.

Local SPPSs should not be required to invest a minimum percentage of its assets in the local market or in local Government securities. Nor should local SPPSs be restricted from investing abroad.

Investment Managers of SPPSs should be subject to strict entry and competence criteria.

It is important to determine whether the local SPPSs will fall under Directive 2003/41 (EEC) or whether it will be subject to the provisions of Regulation (EEC) No 1408/71 and Regulation (EEC) No 574/72, or any other EU Directive. This may influence the regulation of the investment process, in particular the imposition of the investment restrictions recommended from a social policy perspective.

The framework established under the Special Funds (Regulations) Act, 2002 ("the SFA") already provides a sound regulatory framework for the regulation of foreign SPPSs, in line with internationally recommended standards. It is recommended that this framework is utilised for the regulation of local SPPSs. In this regard it is recommended that:

- Any Retirement Funds (for the local or the international market) will be regulated under the SFA, subject to the investment restrictions contained therein and in the supporting Directives.
- From a social policy perspective, the Government requires that SPPSs for citizens of Malta comply with the investment restrictions on the maximum amount of investments in equities and risk capital markets through social policy - in order to protect the retirement benefits of its citizens, particularly if SPPSs are to be mandatory. These restrictions would be over and above those under the SFA. Then the Competent Authority under the SFA registering / licensing these local SPPSs, will require such SPPSs to comply with these restrictions.
- Any voluntary SPPSs aimed at the international market falling under the EU Pensions Directive would continue to be subject to the current framework under the SFA, as may be amended from time to time.

01. Introduction

01.1 Remit of Paper

The remit of this Paper is to consider the comments received on the area of asset investment by Second Pillar Pension Schemes (SPPSs), following the national consultation and discussion process of the White Paper - Pensions, Adequate and Sustainable issued in November 2004.

01.2 Consultation Exercise

The feedback from the consultation exercise on the area of asset investment by SPPSs, can be divided into two sub-categories:

a. feedback regarding the structure of the pension system and
b. feedback regarding the investment allocation framework.

01.3 Structure of the Pension System

Two different positions emerged with respect to the management of pension assets. There are those who are advocating the setting up of a national fund which is managed by Government including the social partners3 and then there are those who promote and endorse the position that the management of assets should be left in hands of the private sector[4].

Those in favour of a national fund argue that:

- such a fund would guarantee that the achievement of the objective of retirement provision and that the benefits would accordingly not be based on the performance of the private sector;
- one fund provides greater economies of scale;
- if the private sector fails, everyone will turn on to the Government;
- it provides greater security (against any potential fraud / mis-management) and enjoys greater public confidence.

Those against maintain that:

- management requires specialised skills and expertise which the state does not possess;
- the private sector is in a better position to ensure efficiency;
- the management of assets by the State could be perceived as indirect taxation;
- the financial services sector already enjoys the trust of the public who trust their savings with this sector.

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[3] MUMN; GWU. The GRTU believes that there should be one pension fund which however should be administered by professional people who would be accountable to contributors and who would need to follow criteria established by Parliament and regulations/ structures approved by the MFSA. Such professional people would also be subject to the supervision of the MFSA. The UHM has proposed a 2 tier system - where the 1st tier is obligatory and handled by Government and the 2nd tier is voluntary. The 2nd tier would be regulated and administered by the MFSA with the participation of the social partners. MUT is not in favour of a mandatory 2nd pillar schemes and recommended inter alia that the State should consider increasing slightly the contribution in the 1st Pillar in good times. This was also the view of the Alliance of Pensioners' Organisations.

[4] Financial Services Consultation Council; Malta Insurance Association; HSBC Bank Malta plc.

The above feedback reflects two different approaches according to where and with whom responsibility for the management of the pension assets should reside (which, according to the World Bank5, is the general sub-division evident in other countries where states have mandated some form of pension provision) whether with the:

a. Private sector in a scenario of employer-based or industry based schemes;

b. the Government in a scenario of publicly managed mandatory pension funds (e.g. Singapore and Malaysia).

The World Bank (2002) also states that a shift towards privatising the management of centralised public schemes has been one of the emerging trends in pension fund provision around the world.6

The White Paper has already tackled this area to some extent (Section 04.2.1 refers) and accordingly this paper will not delve into this aspect. It is however considered important to keep in mind the above views in order to appreciate better the context of the main views received during the consultation process summarised in 01.4 below.

01.4 Investment Framework

The main views from the feedback received during the Consultation Exercise about the investment framework of pension funds may be summarised as follows:

a. the importance that adequate standards are established for the investment management of the assets and that efficiency would be achieved through a properly regulated free market. Such management should follow the prudent man principle. Such standards should ensure safety and security and at the same time provide investment managers with reasonable discretion to enable them to obtain the best returns at acceptable levels of risk;

b. investment restrictions should be limited to ensure diversification and limit employer related investments. Such restrictions should not go into specifying where and what to invest in. No restriction on the geographical area of investment should be imposed and guidelines should be given regarding the split between equity and bonds and the core eligible assets that should feature in pensions-related portfolios identified;

c. the importance that the objectives of pension schemes are achieved as failure to do so would have serious repercussions on the standard of living and on the whole pension system. Hence, the need for a strong and tight regulatory regime to ensure safety of assets and to create confidence in the system. Such a regulatory regime should also be a flexible one in order to allow for efficiency;

d. Whilst it is crucial that the prudent person principle is adopted it is also crucial that prudent investment management parameters are set. It is our opinion that there should be no restriction on the geographical area of investment. This should be a matter for the investment manager to decide depending on where he/she can see most value for his scheme. Similarly it was pointed out that guidelines should be given as to the equity/bond split permitted on pension schemes in such a way as to promote the long term attractions of equities but also not alienating away from the prudent principle aspect.

These last four comments propose that requirements regarding the investment management process of SPPSs should allow certain investment management discretion in the hands of SPPSs, however this should be supported namely by diversification and equity/bond split investment guidelines as well as security measures.

[5] World Bank (2002), The Development and Regulation of Non-Bank Financial Institutions, p.100

[6] ibid, p. 102

e. concern was expressed regarding the negative effects and shocks to the Maltese economy which would result from the outflow of money if a substantial portion of contributions are invested abroad;

If SPPSs are not required to invest at least a portion of the contributions received in local securities (i.e. left to invest the collected contributions outside of Malta), an outflow of capital would result, with the consequent macroeconomic implications associated therewith.

f. the proposed regime provides an opportunity which may be used to support the local capital market (provided however that this does not create inflationary pressures). Such support could have a very positive impact on Malta's economy including the tourism industry. It was noted that pension funds have been major institutional investors in many countries;

The way in which the proposed regime for pension funds may be used to support the local capital market has not been specified. It is assumed that this feedback includes an implied recommendation for requiring SPPSs to invest locally all or a portion of the assets under their management. In theory, such a restriction would help the development of the local capital market. This recommendation includes a proviso that care should be taken not to create inflationary pressures.

01.5 Aims and Structure of the Paper

The Paper aims to address two key questions regarding the Investment Framework:

a. To what extent should pension funds' investments be limited and what type of investment guidelines should be imposed?

b. To what extent should SPPSs be utilised to aid the development of the local securities/capital market?

The two questions raised above are inter-related and hence the Paper is structured in way as to look at both issues separately where possible, but also looking at inter-relationships as these arise.

The Paper is structured as follows:

a. Section 02 looks at the relationship between Pension Funds and Capital Markets and the role of Investment Regulation therewith.

b. Section 03 discusses the characteristics, advantages and disadvantages of the Prudent Man Rule versus the Quantitative Approach in the regulation of the investment management process.

c. Section 04 reviews the investment framework in OECD countries.

d. Section 05 reviews international regulatory developments in this area.

e. Section 06 analyses the recommendations arising out of the Actuarial Study.

f. Section 07 discusses the local capital markets and the regulatory framework under the Special Funds (Regulations) Act, 2002, also taking into account the findings in previous Sections.

g. Section 08 concludes with recommendations.

02. Investment Restrictions, Pensions Funds and Capital Markets

According to the OECD[7], the manner in which assets of a pension fund are invested are relevant for:

a. Retirement income (which in turn incorporates maximisation of returns and security of assets);
b. Development of capital markets.

02.1 Retirement Income - Return on Assets and Security Thereof

The way a pension fund invests its assets is directly related to the risk profile of its portfolio and the return generated on that portfolio.

Achievement of the best possible returns on pension fund investments, without running undue risks[8], is in the interests of beneficiaries (ordinarily these are the retired employees) and contributors (employees and /or employers)[9], as well as the State.

A higher investment performance achieved on the assets of the SPPS, means a higher pension for the beneficiaries - particularly in the case of Defined Contribution Schemes, where benefits are dependant on investment performance and are not defined in advance as in the case of Defined Benefit Schemes.

For the contributor, high investment performance means reduction in the cost of pension provision – as the employee (who contributes out of earned income) and/or the employer (who contributes out of company profits) would not need to resort to increasing his/her contributions relative to the investment return achievable, to earn an adequate pension. This applies in the case of Defined Contribution Schemes as well as Defined Benefit Schemes. In addition, in the case of Defined Benefit Schemes, improved investment return reduces the risk of default on the delivery of the promised benefits by the employer, as the employer would not need to resort to company profits to meet the promised benefits, in turn impacting his business' performance. Reducing the costs of pension for employers can also reduce the cost of employing a person and so directly contribute to creating jobs and to economic growth.

Moreover if low returns on pension fund investments are reflected in lower pensions rather than higher contributions, this serves to increase the burden on State pensions[10].

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[7] OECD, Pension Fund Governance, Investment Strategies, And Their Role In Corporate Governance: *"The investment strategies of pension funds are relevant not only from the perspective of retirement income but also because of their impact on the development of capital markets and the supply of capital for innovative enterprise. Such objectives merit attention in their own right. In addition, capital market development in turn affects the range of investment products and the extent of diversification of pension fund portfolios. There is in essence a symbiotic relationship between pension fund investment and capital market development that may act to the benefit of participants in pension plans*". Available on-line: http://www.djlk.depkeu.go.id/danapensiun/Data/Artikel/investmentstrategies.pdf. Last accessed: 2nd May 2005

[8] High risk investment positions may put the invested assets at risk of being lost with the detrimental consequences such a situation may bring for pensioners as well as the State – economically and socially.

[9] Single Market News: Green Paper on Supplementary Pensions' Potential Role for the Single Market, No. 8, July 1997. Available online: http://europa.eu.int/comm/internal_market/smn/smn08/s8mn06.htm. Last accessed May 2nd 2005

[10] ibid.

02.2 Capital Markets Development

Pension reforms give rise to an important increase in assets under management (the extent depending on whether pension contributions are mandatory or voluntary and on other aspects including, but not limited to, taxation11). SPPS, like other institutional investors, will need an investment outlet for the contributions/assets under their management – thereby increasing demand for securities to invest in.

The SPPSs demand for securities contributes to the development of new and additional financial products within capital markets. It is noted that in certain countries, the accumulation of contributions in the early stages of pension reform, was associated "with the growth of annuities, mortgage bonds and other asset-backed securities, the creation of closed-end mutual funds and local rating companies, as well as the introduction of innovations in securities trading and custody" [12].

SPPSs' demand for securities is also very often linked particularly to the development of the longer-term securities market, given the long-term investment nature of pension funds[13], which development might not be otherwise adequately supported by banks and other institutional investors with a shorter-term focus.

Moreover, increased trading by such institutional investors also adds depth to capital markets where they choose to invest (although it has also been argued that the fact that "pension funds are buy-and-hold investors" does not necessarily contribute to the liquidity of the markets).

In addition, the superior capacity of SPPSs (like other institutional investors) to absorb and process information, and their ability to transact in large volumes, is claimed to lower the cost of intermediation and hence benefits members of pension funds and issuers alike[14]. The former can transact at lower costs and access otherwise inaccessible markets. The latter are provided with alternative means to raise capital, possibly at lower cost, potentially stimulating capital formation in the market where these SPPSs invest.

It is also argued that pension funds are a "positive force … for corporate governance, and for privatisation. Their role in corporate governance arises from the size of their collective voice. Their role in privatisation also derives from their size and consequent capacity to absorb large-scale assets"[15].

02.3 Regulation of Investment Management Process

As seen above, where and how much a pension fund chooses or is able to invest, impacts the risk profile and the maximisation of returns of its assets and the development of capital markets. In turn, the way in which the investment management process is regulated and supervised (i.e. the framework within which pension funds carry out their investment management activity), has a direct and fundamental bearing on these three aspects.

The question is how to create an environment in which asset management can primarily obtain the best returns at acceptable levels of risk[16], bearing also in mind the local capital market development.

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[11] op cit, World Bank (2002), p. 106

[12] Roldos J (2004), Pension Reform, Investment Restrictions and Capital Markets, IMF Policy Discussion Paper PDP/04/4

[13] op cit, World Bank (2002), p. 108-110

[14] op cit, Roldos J (2004)

[15] op cit, World Bank (2002), p. 109

[16] Working Party on Private Pensions (July 2002), "Prudent Person Rule" Standard For The Investment Of Pension Fund Assets, Directorate For Financial, Fiscal And Enterprise Affairs Insurance Committee. Available online: http://www.oecd.org/dataoecd/29/47/1939288.pdf. Last accessed 15th April 2005

There are two main approaches to regulation of the investment process of SPPSs:

a. Prudent Person Rule – a behaviourally oriented standard which does not impose any express restrictions where an SPPS should or should not invest;
b. Quantitative Approach – an outcome oriented focus, which establishes express quantitative limits on the types of assets in which and where SPPSs may be invested.

These two regulatory approaches have been the subject of intense debate in both OECD and non OECD countries as well as within Europe Union in connection with the development of the EU Pensions Directive.

02.4 Summary

The manner in which assets of a pension fund are invested is relevant for retirement income (and hence for maximisation of returns and security of assets) and the development of capital markets

In turn, the way in which the investment management process is regulated and supervised (i.e. the framework within which pension funds carry out their investment management activity), has a direct and fundamental bearing on these three aspects.

The Prudent Man Rule and the Quantitative Approach are the two main regulatory styles adopted for the regulation of the investment management process of pension funds. The adoption of either approach has been the subject to extensive debate within regulatory circles across the OECD and the EU.

03. Prudent Man Rule vs Quantitative Approach

This Section discusses the Prudent Man Rule and the Quantitative Approach - by first looking at the Prudent Man Rule and then at the Quantitative Approach, analysing the advantages and disadvantages associated therewith from a security and investment performance aspect, as well as looking at their contribution to local capital market development.

03.1 Prudent person rule

Prudent person rule:

a. is generally defined as acting with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of similar activities, with similar aims;

b. is a behaviourally oriented standard, focusing on how diligently the appointed person performs his or her obligations with respect to the pension plan, including how investment management decisions are made. Investment Managers "are intended to be judged not by retrospective assessment of whether their investment decisions were successful, but by whether they followed a reasonable process in reaching their decisions. Prudence demonstrated by the process through which risk is managed, rather than by the definition of specific risks that are imprudent"[17];

b. it imposes a standard of care, skill and diligence, loyalty and prudence and diversification. This standard generally involves:
   - a requirement of competence on behalf of the Manager responsible for the assets of the SPPS (i.e. Principle of Skill and Diligence);
   - elements of monitoring of the investment management function – internal as well as external through custodians and/or administrators (i.e. Principle of Prudence / Care);
   - a requirement for the review of the statement of investment principles or investment policy on a regular basis, as a tool to guide investment management decision-making (i.e. Duty of Prudence);
   - a requirement that the manager manages the assets in the best, sole or exclusive interest of beneficiaries (i.e. Duty of Loyalty). This duty includes prohibitions on self-dealing in the management of the pension fund's assets and on engaging in conflict-of-interest transactions adverse to the interest of plan members[18];
   - an effective reporting and disclosure regime. There should be adequate information made available to the supervisory authority and members of SPPSs;
   - availability of adequate remedies. Supervisory authorities and members should be able to initiate legal proceedings, whether judicial or administrative, when improper actions are discovered;
   - does not include any quantitative restrictions, other than restrictions imposing diversification requirements to ensure avoidance of undue risk, including prohibition of self-investments (i.e. Principle of Diversification).

03.1.1 Return

The main strength of the prudent man rule is its flexibility as it gives the freedom to investment managers to maximise investment opportunities and respond efficiently to the changing nature of financial markets. This flexibility, if used properly, may lead to maximisation of investment returns.

[17] op cit, Working Party on Private Pensions (July 2002)
[18] op cit, Working Party on Private Pensions (July 2002)

03.1.2 Security

However in its purest form, the flexibility of the prudent person rule is also its greatest weakness. In its purest form (as its precise parameters may vary), this rule would give investment managers an open-ended authority with no restraint or guidelines, which could easily lead to potential abuse by the investment manager, unduly raising the risk profile of a SPPS. However, the duty of care, diversification, prudence and loyalty as a complement to this rule, are extremely important to mitigate this risk. It has been affirmed that if the underlying principles of duty, diversification, loyalty and prudence are understood, enforceable and enforced, then "they have a remarkable ability to corral investment activity into a framework of reasonable behaviour". Studies have shown that such rules have significantly curtailed adventurous asset management[19].

Further to the above, it is to be noted that investment management decisions are not readily assessable as compared to clear quantitative limitations. Investment management decisions may however be monitored through regular comprehensive reporting. To also note that this rule relies on the courts to determine substance of the principle. Where court systems are not well developed and not reliable, the result can be long delays and inconsistency in the establishment of precedents[20].

03.1.3 Capital Market Development

Moreover, this approach would leave investment managers free to invest in any type of security and in any market. This may lead investment managers to invest all the assets of an SPPS outside the country, leading to capital outflows with their consequent macroeconomic implications and potentially foregoing an opportunity to contribute towards the development of the capital market where the SPPS is located. However, to note that the development of a capital market is not dependent solely on where an SPPS invests its assets.

A summary of the main advantages and disadvantages of the prudent man principle are included in Table 1.

Table 1 - Advantages and disadvantages of the Prudent Man Rule

Advantages of the prudent man principle	Disadvantages of the prudent man principle
Flexibility and Optimisation of Returns	Total reliance on Manager of SPPS
- Provides flexibility to asset managers needed to make investment management decisions in the ever-changing environment of financial markets – with new products being issued and new risks being faced and new risk management techniques being adopted. This allows investment managers to view portfolios as a whole and hence optimise investment performance of that portfolio.	- Complete reliance on Manager of SPPS. Potential room for abuse of the situation by the service provider, with the possibility of an increase in the risk profile of that SPPS. - (This however may be counteracted by the principles of diversification, care and loyalty, as well as by guidelines/requirements based on competence, disclosure and monitoring measures).
	Not easily assessable
	- Investment Management decisions are not readily assessable as compared to a clear quantitative limitations. (This may be counteracted by effective and

[19] op cit, Working Party on Private Pensions (July 2002)
[20] op cit, World Bank (2002), p.124

regular reporting and monitoring).

- It relies on the courts to determine substance of the principle. Where court systems are not well developed and not reliable, the result can be long delays and inconsistency in the establishment of precedents[21].
- Potential Capital Outflows and Foregoing Opportunity of Contributing to the Local Capital Market

- Freedom of investment by the asset manager can lead to all contributions being invested outside the country, meaning loss of huge capital and foregoing opportunity to aid the development of the local capital market.

03.2 Quantitative Restrictions

Quantitative restrictions involve specific limits restricting investments of SPPSs not only from a diversification aspect, but also restricting a pension fund where to invest and in what type of asset category it may invest – such as requiring a SPPS to invest domestically versus effecting foreign investments or requiring a SPPS to invest all or a high proportion of its assets in bonds versus equities.

03.2.1 Security

One main argument cited in favour of this approach is that it ensures security of investments, and safeguards pension participants from a number of capital market risks – as managers are obliged to invest in low risk assets (such as bonds versus equities). Moreover, these restrictions are easily measurable and hence investment managers' activities can be easily monitored.

However, it is often argued that such restrictions limit the adequate diversification of the portfolio and in actual fact increase rather than minimise the risk profile of a SPPS.

03.2.2 Return

Quantitative restrictions (when not prudentially justified) are inflexible and inhibit the best possible investment allocation and accordingly they hinder the possibility to achieve better returns. Prescriptive restrictions would not allow investment managers to take advantage of market opportunities and developments as they arise and may limit investments to instruments which may not necessarily provide the best returns without undermining security and prudence. This risk of not optimising returns is more pronounced in cases where a pension fund is obliged to invest in a particular market or particular asset category, and that market or asset category is characterised by lack of diversity and availability of securities, including securities within the specified asset category.

[21] ibid, p.124

Moreover, SPPSs and also other institutional investors, may distort asset prices and magnify volatility in asset markets where they are obliged to invest – particularly in small capital markets and markets characterised by lack of securities[22]. Due to the large volume of assets under management relative to the size of the market, SPPSs may find themselves able to move prices in small and narrow markets. This could lead to liquidity constraints where SPPSs cannot sell assets without putting downward pressure on prices. Moreover, where demand for securities exceeds supply, issuers may hike up prices of securities without any strong financial backing, leading to potential price bubbles. All these risks / consequences could lead to losses on investments of SPPSs.

03.2.3 Capital Market Development

Quantitative restrictions have a direct impact on the development of the market where a SPPS is required to invest or on the market of the type of asset a SPPS is obliged to take up. The quantitative restrictions ordinarily influential in this regard, include:

a. requiring a SPPS to invest all or the majority of its assets in the national capital market (domestic versus foreign investments);
b. requiring a SPPS to invest in bonds versus equities;
c. requiring a SPPS to invest in government bonds.

Domestic vs Foreign Investments

Allowing foreign investments, may limit the development of the local securities market, as SPPSs may elect to invest the majority of the contributions under their management in foreign capital markets rather than locally – potentially foregoing the theoretical development of the local capital market. Moreover, foreign investments amounts to capital outflows, with the resultant potential macroeconomic consequences associated therewith.

However, requiring SPPSs to invest all or the majority of the collected contributions in the local capital market, would result in a situation of:

a. lack of country diversification – which may raise the risk profile of portfolios;
b. tying the performance of SPPSs with the performance of the local economy. This raises the risk of an individual being faced with inadequate retirement benefits at a time when the economy is in dire straits.

These associated risks may reduce the "security" of SPPSs' investments.

Moreover, international investments may allow superior performance in terms of risk and return – and allow for optimisation of the performance of the SPPS. Diversification of portfolios is always advocated. Besides "labor income is much more correlated to domestic financial assets returns than to foreign asset returns. Hence international investment provides also hedging benefits for labor income"[23].

[22] op cit, Roldos J (2004)
[23] ibid

Bonds versus Equities

In terms of portfolio theory, equities are considered as more risky investments than bonds as they imply exposure to high volatility risks which in a sense are random[24]. This volatility risk may impinge on the returns made by a SPPS, particularly if equity investments need to be liquidated at a point where equity markets are not performing well. –The idea of limiting equity investments by a SPPS emanates from this concept, with the intention of limiting over-exposure to equity investments and hence limiting undue volatility of portfolios of SPPSs. However on the other hand, it is argued that equities carry higher expected returns than bond investments, as and hence restricting SPPSs to invest the bulk of their assets in bonds would deprive investment managers from optimising the performance of the respective portfolio. It is also argued that it may be better for a young SPPS (when compared to a mature SPPS which needs income generating securities in its portfolio) to invest the majority of its assets in equities versus bonds as equities are generally considered to provide substantial return if one invests in the long term. In fact, studies about the return on equities in the US market for all the 20 year periods that there have been since 1926 to 2001, show that over all of those periods there has been a mean return on equities, of 7.2% per annum in real terms. However the problem is that there have been some 20 year periods where real returns have been over 13% real, and others where it has been less than 2%[25]. In fact, the recent dismal performance of equity markets have hurt beneficiaries' pension benefits[26].

Different ideas regarding the ideal mix of bonds and equities in portfolios exist in this regard[27]. Principles of portfolio choice state that all investors should hold the same portfolio of risky assets, a unique and optimal mix of stocks and bonds, with conservative investors holding relatively more cash. This position contrasts with the advice of financial planners, who effect portfolio allocations depending on the investors' degree of risk aversion – on average conservative investors are told to hold a much higher allocation in bonds than in equities. Moreover, recent studies showed that the optimal portfolio allocation may vary between long term and short term investors and the context of the market in question.

One certain aspect is that risk should be measured relative to the existing overall portfolio. Moreover, diversification arguments suggest that equities should continue to be part of optimal pension fund portfolios.

Investments in local government bonds

Three arguments are generally cited in favour of this type of investment restriction[28]

a. Increased government bond issuance would smooth "the transition to a funded system and attenuate the problem that the transitional generation would have to "pay twice", that is pay contributions to the Pay-As-You-Go ("PAYG") system to finance benefits of those who are already retired while also saving for their own future retirement".

b. Pension fund managers in the early stages of pension reform would be relatively inexperienced and need to follow a learning process that would start with less risky government bonds.

c. Local bond markets are generally underdeveloped and so it would be appropriate for government to take the lead.

Arguments (b) and (c) may however not be valid in the context of particular capital markets – such as the Maltese market.

[24] The Macro-Economics of Pensions, Lecture to the Actuarial Profession, September 2nd 2003, p.7
[25] ibid
[26] op cit, Roldos J (2004)
[27] ibid
[28] ibid

Arguments against traditional quantitative restrictions include:

a. An undesirable concentration of risk in the sovereign. The 2002 Argentine crisis highlighted the risks involved in a concentrated exposure to a sovereign. In December 2001, Argentina stopped honouring its debt due to negative economic and fiscal policies, and defaulted on its sovereign bonds worth $81 billion, leaving to more than 500,000 aggrieved creditors. The majority of these creditors eventually surrendered their claims in exchange for new bonds worth roughly 35 cents on the dollar, through a debt swap, which bonds could then be exchanged for three new issues[29]. Concentration of exposure to any one party, even in sovereign bonds, raises the risk profile of a portfolio.

b. SPPSs end up assuming a role in ensuring a reliable source of public finance through government bonds[30]. This would defy the primary objective of a SPPS which is to provide adequate retirement benefits to beneficiaries.

c. Potentially limiting the optimisation of return by the SPPS.

Table 2 - Advantages and disadvantages associated with quantitative restrictions

Advantages of onerous quantitative restrictions	Disadvantages of onerous quantitative restrictions
Easily monitored as they are quantified	
Provide some controls on the investment management thus controlling risk positions taken by Investment Managers	*Inadequate Diversification* Appropriate diversification can eliminate any particular risk. International investment will actually reduce otherwise undiversifiable risk.
Restricts Capital Outflows	*Potentially Defies Aim of SPPS* Potentially used as monetary tools or source of public finance – not in line with the objective of the pension fund.
Aids development of local capital market Increases demand for local securities, potentially leading to innovation, increased trading and hence broadening and deepening the local capital market.	*Restricts the benefits to the capital markets, leading to inefficient allocation of capital and higher costs – particularly in small and narrow capital markets* Where pension funds are compulsorily funnelled into government bonds, which must themselves be repaid from taxation, there may be no benefit to capital formation and the 'funded' schemes may at a macroeconomic level be equivalent to PAYG[31]. General restrictions also complicate and obstruct the functioning of an efficient capital market and increases the cost of raising capital for companies and the public sector. Investment by SPPSs particularly in small markets characterised by lack of securities and demand greater than supply,

[29] A Victory by Default? The Economist Global Agenda, March 4th, 2005. Available online: http://www.economist.com/agenda/displayStory.cfm?story_id=3734352 Last accessed 20th June 2005

[30] Chetchuti JP (2002), Liberalisation of Pension Investment. Available online: http://www.inter-lawyer.com/lex-e-scripta/articles/eu-pensions-regulation.htm Last accessed 15th April 2005

[31] ibid

could lead to price distortion and increased price volatility.

Pension Fund investment horizon changes / differs between funds, depending on the nature of the members of that Fund – a young fund can afford more liquidity risk and asset class risk than a mature fund. A Pension Fund may be restricted by quantitative restrictions from adjusting its investment positions according to its needs. This leads to inefficient allocation of capital – which in turn prevents levels of economic growth and increase in employment otherwise attainable through efficient capital allocation.

Investment restrictions are inflexible/ may increase risks and unnecessarily limit fund performance

Investment decisions cannot respond rapidly to changing economic circumstances and movements in markets.

Encourages managers to conform with legal restrictions rather than strive for optimal performance.

03.3 International Studies

Various studies have been carried out regarding investment performance under the prudent person rule. This literature consistently suggests that on the whole, investment managers subject to the prudent person rule invest cautiously[32].

Other studies have also tried to compare the investment returns of pension funds which are subject to quantitative investment returns and those following the prudent man rule. These studies suggested that on average quantitative restrictions (such as those in real estate or foreign assets) constrained the asset allocation of the average pension fund and that where a prudent person rule, rather than quantitative restrictions was applied, greater investment returns where generated. However these studies are considered to be suggestive rather than conclusive due to certain influences on portfolios that may complement, over-ride or interact with the effect of portfolio regulation and which were not taken into account[33].

03.4 Summary

The Prudent Man Rule avoids the imposition of stringent portfolio limits and focuses on regulating the behaviour of investment managers. Very often this Rule is complemented by the Principles of Care, Loyalty, Prudence and Diversification.

The Quantitative Approach prescribes various investment limits which investment managers are obliged to follow in their portfolio allocation on behalf of pension funds.

[32] op cit, Working Party on Private Pensions (July 2002)
[33] ibid

Both approaches have advantages and disadvantages – relevant from the perspective of security of the pension fund assets and the optimisation of investment performance. In this regard, international studies suggest that:

a. The Prudent Man Rule is best placed to the optimisation of investment performance by the assets of pension funds.
b. In so far as security of assets is concerned, the Prudent Man Rule, when coupled with the duty of care, diversification, prudence and loyalty has curbed any adventurous activity by investment managers.

Quantitative investment restrictions appear to have direct impact on the development of local capital markets – through the imposition of investment restrictions which obligate a SPPS to channel funds in particular markets or particular asset categories. However such an approach needs to be viewed within the contexts of the local capital market – since the benefits of capital market development may not necessarily materialise in the fashion envisaged theoretically, particularly in small and narrow capital markets where certain type of quantitative restrictions may have negative repercussions.

04. Investment Regulation of Pension Funds in Other Countries

This Section seeks to review the Investment Regulation of Pension Funds in Other Countries.

04.1 Regulatory Approach in Other Countries

Tables 3 and 4 attached as Appendix 1 are taken from a Survey carried out by the Directorate for Financial, Fiscal and Enterprise Affairs, Insurance Committee (DAFFE/AS/PEN/WD(2000)13/REV2). The Survey regarded the Investment Regulation of Pension Funds in OECD Countries.

Following is an extract from the Survey regarding its main findings:

a. Some form of quantitative regulation is applied in all member countries. Most commonly, regulations limit conflict of interest between plan members and pension fund managers
b. In all countries, except Japan, pension funds are subject to self-investment limits. The ceiling varies between countries, ranging from 25% in Finland and Switzerland to 2% in Denmark and Germany. However usually the limit is set at 5%.
c. Many OECD countries also limit investment in a single issue or in securities from the same issuer. The limit is usually set at around 10% of the fund, though in some countries it is higher (e.g. Italy at 15%)
d. Some countries also impose limits on ownership concentration, that limiting the exposure to a single issuer. The ceiling ranges from 30% in Canada to 2% in Denmark.

[The above limits are generally imposed to ensure diversification and limit concentration of exposure in any one country or in the employer.]

e. About half of the OECD countries where pension funds exist also place limits by asset type (Table 3). The most common are limits on equities and foreign securities. Equity limits are applied by sixteen of the twenty-seven OECD countries with pension funds. These limits range from 60% in Sweden to 0% in Mexico. Table 3 lists the countries and limits in equities. Some countries also place tighter restrictions on investments in unquoted shares. This is the case in Belgium, Finland and Portugal.
f. Eleven OECD countries place no limits on investments in equities.
g. Countries that limit investment in equities tend also to restrict investment in other asset categories, such as property. The ceilings range from 50% Switzerland to 0% for Hungarian and Mexican mandatory pension funds. In general the limit for direct investment in property is lower that that for equities. The only two exceptions are Finland and Switzerland, where pension funds are allowed to invest a greater percentage of their asset in real estate than in stocks.

[The position regarding imposition of limits on equity investments varies and appears to be split – with about half imposing limits and around one third imposing no limits.
Moreover, some countries also impose limits on investments in unquoted securities and investments in immoveable property – given that these are generally considered investments of a higher risk nature than investments in quoted securities]

h. Various countries also limit loans by pension funds (Austria, Czech Republic, Finland, Germany, Hungary, Mexico, Poland and Portugal). The limit ranges from 70% in Finland to 0% in the countries with open funds (Hungary, Mexico, Poland and Czech Republic).
i. Investment limits in other domestic assets such as bonds and bank deposits are much less extended. Limits on corporate and mortgage bonds are imposed only in Germany, Hungary, Mexico and Portugal. A few countries also place limits on investment in liquid assets such as deposits (Germany, Italy, Portugal and Spain).

[Limits on investments in domestic assets are not widespread]

j. While no OECD countries impose ceiling on investment in government bonds, two countries apply floors. In Austria, pension funds are required to invest at least 35% of their assets in mortgage bonds, government bonds, and euro denominated debentures. In Mexico, pension funds must invest at least 51% of the funds' assets in inflation-linked or inflation-protected securities and at least 65% in securities that either have a maturity shorter than 183 days or have floating rate notes whose rate is revised in less than 183 days.

[The majority of countries do not impose any limits on investment in government bonds]

k. Some countries restrict investment in foreign securities, either through direct ceilings or via currency matching rules. The latter are present in Finland, Germany and Portugal, where pension funds are required to cover at least 80% of their liabilities with assets in the same currency and Italy, where the minimum level is 33%.

Direct limits on foreign securities exist in some countries, ranging from 65% in Belgium to 0% in Mexico. Most countries that limit investment in OECD countries impose even tighter limits on investment in securities from non-OECD countries. In fact, only a few countries permit investment in non-OECD securities, including Australia (no limit), Canada (30% limit), Hungary (9% for mandatory pension funds, 6% for voluntary pension funds, investment in non OECD equity not permitted), Ireland, Italy (5%), Netherlands(no limit), New Zealand (no limit), Norway (no limit), Portugal (20% limit), the UK (no limit) and USA (no limit).

[The approach regarding investments in foreign assets appears to be mixed Various countries impose direct or indirect limits on international investment, also differentiating between OECD and non OECD countries and EU countries]

The approach adopted varies between countries, bearing in mind the respective different contexts and particular economic and capital market characteristics. While in particular the Anglo-Saxon countries, pension funds are required to follow "prudent man rules", no emerging market is allowed to follow the prudent man rule[34]. However emerging markets usually have to contend with underdeveloped capital markets, limited foreign exchange reserves and poor regulatory foundations[35]. Moreover, quantitative restrictions have direct implications depending on the state of the respective capital market (e.g. underdeveloped vs developed capital markets), as seen in 03.2.3 above.

To also note that the above data is as at December 2001, and hence may be slightly outdated. All EU countries mentioned in the survey are in the process of revising their investment restriction requirements on SPPSs falling under the EU Pension Directive in line with the requirements of this latter Directive.

Two classifications of SPPSs are relevant from the perspective of investment regulation – mandatory vs voluntary pension funds and open vs closed pension funds[36].

Mandatory pension funds are ordinarily subject to more stringent regulations than voluntary pension funds (e.g. Hungary). This is generally due to the fact that compulsion of contributions in mandatory pension funds puts a higher degree of responsibility on the Government with respect to the provision of adequate retirement benefits by these funds, since the individual does not have the freedom to choose his/her own level or form of retirement savings. This strengthens the case for some form of regulation. Where pension funds are entirely voluntary, these are treated like ordinarily investment vehicles and there is only a weak case for regulating them much beyond the level of regulation applied to collective investment schemes[37].

In most countries, closed and open pension funds are subject to the same investment regulations – although in Mexico different regulatory regimes exist for these classes of funds.

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[34] op cit, Roldos J (2004), p.10
[35] op cit, World Bank (2002), p.128
[36] Closed funds support a retirement plan restricted to specific participants (e.g. employees from a specific company, industry or government agency), while an open pension fund supports retirement plans that do not have membership restrictions.
[37] op cit, World Bank (2002), p. 112

04.2 Summary

According to data as at December 2001, the approach varies between OECD countries – although findings suggest that:

a. The imposition of quantitative restrictions is generally aimed to ensure diversification and prohibit self-investment.

b. The position regarding limitation of equity investments is split.

c. No country imposes ceilings on investments in government bonds, with only two countries impose floors in this regard.

d. Limits on investment in domestic assets are not wide-spread.

e. Various countries impose direct or indirect limits on international investment, also differentiating between OECD and non OECD countries and EU countries.

While in particular the Anglo-Saxon countries, pension funds are required to follow "prudent man rules", no emerging market is allowed to follow the prudent man rule[38]. This difference in approach may be due to the context prevalent within respective countries – where emerging markets, compared to developed countries - usually have to contend with underdeveloped capital markets, limited foreign exchange reserves and poor regulatory foundations[39].

The regulatory approach in certain countries appears to be influenced by whether a pension fund is voluntary or mandatory. This is due to the fact that in a mandatory environment, the Government assumes a higher degree of responsibility and hence there is a 'stronger' case for a more stringent regulatory approach than for voluntary pension funds.

[38] op cit, Roldos J (2004), p.10
[39] op cit, World Bank (2002), p.128

05. International Regulatory Approach

The next Section looks at the regulatory approach advocated internationally in the area of investment management of pension fund assets

05.1 International Regulatory Approach

05.1.1 Investment Restrictions - European Union, OECD and INPRS

The EU Pensions Directive[40]

The EU Pensions Directive which Malta has to adopt and implement by September 2005, sets out the 'prudent person rule' as the underlying principle for the investment of the assets of SPPSs (i) not covered by Regulation (EEC) No 1408/71 and Regulation (EEC) No 574/72 (ii) the non-mandatory pension business of SPPSs considered to be social security schemes covered by the latter Directives (iii) fully-funded SPPSs (iv) as well as SPPSs which are not book-reserve schemes, amongst others[41].

Apart from the 'prudent person rule' the EU Pensions Directive - Article 18 (Appendix 2 refers) - specifies a number of investment principles which must be adhered to. The EU Pensions Directive explicitly states that the assets are to be invested in the best interest of the members and beneficiaries of such schemes (and in the case of potential conflict of interest in the sole interest of members and beneficiaries). One particular rule relevant to national investment restrictions is that EU member states cannot impose requirements for investments to be made in particular categories of assets.

In addition, the EU acknowledges that there are different supervisory practices and methodologies within its member states, and it provides certain limited discretion on the investment rules which countries may impose on occupational schemes based in their territories[42]. The imposition of quantitative restrictions is allowed as long as these are justified on a prudential basis and in accordance with the prudent person principles laid down in Article 18(1) of the EU Pensions Directive (for example to ensure diversification, ensure that assets are invested predominantly on regulated markets, limit employer-related investments to 5% of the SPPS's assets). Notwithstanding, the imposition of quantitative restrictions is subject that SPPSs covered by the EU Pensions Directive are not prevented from:

a. investing up to 70% of the assets in shares, negotiable securities and deciding in the relative weight of these securities in their investment portfolio (this 70% limit may be reduced if it is prudentially justified in the case of SPPSs which provide retirement products with a long-tern interest rate guarantee, bear the investment risk and themselves provide for the guarantee);
b. investing in risk capital markets;
c. investing up to 30% of assets covering technical provisions in assets denominated in currencies other than those in which the liabilities are expressed.

This Directive in fact specifies that there should be freedom of investment which should only be subject to coordinated prudential requirements. Accordingly, whilst acting within the prudence concept which may be supplemented by quantitative restrictions to ensure diversification and limit certain risks (e.g. limit investments in unlisted securities and management of risks associated with derivative investments), there should be sufficient flexibility to enable the investment manager to adopt the most

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[40] Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision

[41] Articles 2 and 3 of Directive 2003/41. To note that the EU so far has left the structuring of the local pension system at the discretion of national Governments. The EU Pensions Directive is only intended to harmonise the regulatory framework forSPPSs which are not covered by Regulations (EEC) No 1408/71 and (EEC) No 574/72, and for the non-compulsory business of SPPSs covered by these latter Directives, so these can operate on a cross-border basis.

[42] Article 18(5) of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision

secure and efficient investment policy. This Directive highlights that the asset allocation should be done by taking into consideration the composition of the members of the occupational pension scheme. The asset allocation should in fact precisely match with the nature and duration of the scheme's liabilities.

In case of cross-border activities the EU Pensions Directive provides discretion to an EU member state - the home state - to impose certain investment rules on occupational retirement structures based in the host member state as long as these are prudentially justified and as long as such restrictions are also applied in the home state.

The above EU requirements regarding the regulation of investment activities of SPPSs determines the regulatory approach that each Member State may apply to SPPSs . In this regard:

a. SPPSs which not covered by Regulation (EEC) No 1408/71 and Regulation (EEC) No 574/72 as well as the non-mandatory pension business of such SPPSs considered to be social security schemes covered by the latter Directives, as well as other SPPSs which are not excluded by Article 2 of this Directive[43], are obliged to follow the investment approach in the EU Pensions Directive.
b. Any other SPPSs would be subject to any provisions included in Regulation (EEC) No 1408/71 and Regulation (EEC) No 574/72.

The International Network of Pension Regulators and Supervisors ('INPRS')

In April 2001, the INPRS endorsed 15 principles which cover best practice in the area of occupational pension schemes. These principles were drafted by an OECD Working Party on Private Pensions. One principle focusing on investments states the following:

> "Investment by pension funds should be adequately regulated. This includes the need for an integrated assets/ liabilities approach, for both institutional and functional approaches, and the consideration of principles related to diversification, dispersion, and maturity and currency matching. Quantitative regulations, and prudent-person principles should be carefully assessed, having regard to both the security and profitability objectives of pension funds. Self-investment should be limited, unless appropriate safeguards exist…".

The INPRS has also issued a number of selected principles for the regulation of investments by occupational pension schemes. Full details of the selected principles are included in Appendix 3. The main points arising from these principles are the following:

a. investments should be adequately regulated;
b. self investment should be limited;
c. there should be no quantitative restrictions – i.e. No minimum level of investment should be prescribed for any given category of investment except on an exceptional and temporary basis and for compelling prudential reasons. Maximum levels, if imposed, may be justifiable to allow certain flexibility to firms and allowing ceilings to be exceeded in certain circumstances;
d. restrictions imposed with respect to special risks e.g. self-investments;
e. certain categories may be strictly limited due to certain risks e.g. unquoted shares;
f. quantitative limitations which for example limit adequate diversification should be avoided. Maximum levels of investments should only be introduced if in consistence with the principles of diversification, dispersion and maturity, and risk management to avoid excessive risk concentration.

[43] Article 2 of Directive 2003/41/EC:

05.1.2 Capital Flows – EU / OECD/ INPRS

EC Treaty and Directive 88/361/EEC

To note that[44]:

> "Article 56(1) (formerly Article 73(b)(1)) of the EC Treaty guarantees the basic principle of free movement of capital by prohibiting all restrictions on the movement of capital between Member States, and between Member States and third countries:
>
> "Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited".
>
> Although the Treaty does not define the term 'movement of capital', it is a settled case law that Annex 1 of Directive 88/361/EEC (which originally implemented Article 56), including a nomenclature of the capital movement referred to in Article 1 of the Directive, may be used for the purposes of defining what constitutes a capital movement. The nomenclature provides a non-exhaustive list of capital movements which includes investments in units of undertakings for collective investment, as well as direct investment and investments in real estate (both on national territory by non-residents and abroad by residents).
>
> The free movement of capital may be lawfully restricted by national rules which are justified by reasons referred to in Article 68 (formerly Article 73d), or by overriding requirements of the "general interest". However the European Court of Justice ("ECJ") has held that these derogations must be restoratively interpreted and their scope cannot be determined unilaterally by the offering Member State. Moreover, the principle of proportionality must be respected: the national legislation must be appropriate for securing the objective which it pursues and must not go beyond what is necessary in order to attain it. The ECJ has also held that the general financial interests of a Member State cannot constitute adequate justification for restrictions on investment and that economic grounds can never serve as a justification for obstacles prohibited by the Treaty".

OECD / INPRS

The Principles covering best practice in the area of occupational pension schemes drafted by an OECD Working Party on Private Pensions and endorsed by the INPRS state that:

> "Liberalisation of investment abroad by pension funds should be promoted, subject to prudent management principles."

An OECD Principle specifically states that:

> "Investment abroad by pension funds should not be prohibited".

05.2 Summary

The OECD and the INPRS, as well as the EU in so far as SPPSs, amongst others, falling outside the EU Pensions Directive are concerned, recommend the application of the prudent man principle and the avoidance of quantitative restrictions, unless justified on a prudential basis.

In so far as capital controls are concerned, all entities recommend that no capital restrictions are imposed. Moreover, the imposition of capital controls can go against the freedom of capital requirements in terms of the EU Directive on Capital Flows.

[44] Advisory note obtained from Dechert LLP

06. Actuarial Recommendations

The next Section reviews the actuaries' recommendation regarding the regulation of the investment management process of SPPSs in Malta.

06.1 Recommendations by Hewitt Bacon & Woodrow Ltd

The following is a summary of the main recommendations made by Hewitt Bacon & Woodrow ("the Actuaries") in their actuarial study on the investment of pension assets:

a. a common set of investment principles and limits should be applied;

b. a maximum % of how much assets could be invested locally should be determined – and this would be established by reference to the artificial inflation such assets could have on the prices of local assets;

c. the maximum % in local assets should be set at a fairly low figure, if not at 0% as done in some countries;

d. the maximum % should also cover investment in local property;

e. limit very tightly any investment in Maltese Government securities;

f. assets should be diversified by type of investment, industry and country and limits set up for each sector. A maximum exposure should also be imposed on investments in a single entity;

g. a limitation on self-investment is introduced;

h. most of the assets should be marketable;

i. prescriptive limits or ranges are not set on the main categories of assets (like bonds, equities and property) or if set should afford certain degree of flexibility;

j. gearing should be restricted and the use of derivatives should be focused on achieving diversification and risk reduction.

With respect to limitation on investments in the local market, the actuaries argued that investment within Malta could have significant economic implications. Given the limitations to diversify investments within Maltese equities there should be diversification outside Malta. With respect to investments in Maltese Government securities, the actuaries questioned the rationale for increasing the exposure to Government given the considerable exposure that already exists through the contributions in the first pillar. It was also argued that the return on Government securities (and also those of other EU countries) may also not be attractive unless such securities provide returns linked to the retail price index inflation.

Investments in the local market would expose contributors to a number of interdependent risks (such as the risk of poor performance of the local economy; under/low performance of Maltese securities; low rates of local wage growth as compared to Retail Price Index ("RPI") inflation which in turn would have negative effects on the first pillar).

The Actuaries are not recommending the quantitative restrictive approach – rather they suggest the adoption of the prudent man rule (recommendations a, e-i), supplemented with the quantitative restrictions regarding investment in local property – recommendation (d), investments in local Government bonds – recommendation (e), imposing diversification requirements by asset type (i.e. by bonds and equities), by industry and by country – recommendation (f), limiting self-investments – recommendation (g), limiting the majority of investments to marketable instruments, that is limiting investments in unquoted securities – recommendation (h), restricting gearing – recommendation (j), and limiting the use of derivatives be limited for risk management and diversification purposes – recommendation (i).

With reference to Recommendations (b) and (c), the Actuaries tend to favour an approach where SPPSs are not subject to any restrictions on local or foreign investments – however should a limit be placed on local investments, they advise that caution should be exercised with respect to the pricing of securities in the local capital market.

06.2 Summary

The Actuaries also recommend the adoption of the prudent man rule supported by diversification rules and limitations focused solely on marketable instruments and regulating the use of derivatives, prohibitions of self-investments and limiting investments in local properties. The Actuaries made these recommendations also taking into account the local context – and the current stage of development of the local capital market.

07. Local Scenarios

This Section looks at the local scenario with reference to the findings in the previous Sections, and concludes with the approach considered applicable for the local SPPSs.

07.1 The Local Capital Market

Structural infrastructures are already in place in Malta – unlike many emerging countries who had poor regulatory structures for their capital markets when they initiated their respective pension reform[45].

However development of the local capital market has been limited to date. In its 2003 Financial Stability Assessment Report on Malta, the International Monetary Fund ("IMF") described the Maltese domestic capital market as small, with a limited number of available investment vehicles and the secondary market as very thin – as evidenced by the Table A in Appendix 4.[46] Without analysing the underlying reasons regarding the historical development of the local capital market (which is outside the scope of this Paper), the main and active issuer of securities since the Malta Stock Exchange commenced operations in 1992, has been the Government of Malta with its long-dated bonds. The private bond market has been slow to respond, although 2002 saw various companies issuing bonds on the local stock exchange, but the momentum was not subsequently maintained in 2003 and 2004. Between 1992 and end December 2004, only a total of 17 companies opted to raise funds through publicly listed bonds on the local stock exchange. Similarly, only 13 companies opted to raise equity through the local public, although some of these issuers have made more than one equity issue[47]. Table B in Appendix 4 includes an analysis of the number of different issuers on the Malta Stock Exchange.

07.1.1 Local Investments

If a quantitative approach where to be adopted which restricts SPPSs to channel all or a substantial part of their assets locally, it is doubtful whether, or to what extent the local market would respond to increased SPPS demand for securities with a substantial volume of assets and enough diversity of securities.

Given the small size and lack of available instruments and the small number of qualifying companies in the local market, growing SPPSs could potentially quickly reach limits restricting their investment in the local market, increasing the risk of price bubbles. The risk of price distortion and increased volatility – as discussed in 6.0 above – would appear to be quite relevant within the local context..

07.1.2 Foreign Investments

Moreover, restricting foreign investments of SPPSs, may result in SPPSs investing relatively large portions of their portfolio in government bonds particularly given the lack of securities and issuers in the local capital market – and given the fact there exists a well-developed long-term government bond market.

In addition, although allowing foreign investments would result in capital outflows with consequent macroeconomic implications, it is to be noted that:

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[45] op cit, World Bank (2002), p.128

[46] International Monetary Fund, 2003, Malta: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, Corporate Governance, and Payment Systems. Available online http://www.imf.org/external/pubs/ft/scr/2003/cr03264.pdf. Last accessed 24 May 2005; p.28-29.

[47] Malta Stock Exchange Statistics

a. Restricting foreign investments, unless justified on prudential grounds, may amount to a capital flow restriction in breach of the EU Capital Flow Directive.

b. Malta has been pursuing a policy of gradual liberalisation of capital flows over the past years. In fact, last year it phased out the exchange control restrictions[48]. Moreover, to date, no foreign investment restrictions have been imposed on other institutional investors such as collective investment schemes licensed under the Investment Services Act, 1994 or life assurance companies licensed under the Insurance Business Act 1998.

07.1.3 Investments in Local Government Bonds

Also in certain markets, SPPSs' managers may be relatively inexperienced in asset and risk management and it is considered that they may need to follow a learning process starting with less-risky government bonds[49]. In the case of the local market, certain institutions (for example life assurance companies and fund managers) have already gained substantial experience in portfolio management – although not necessarily with the aim of providing retirement benefits. The case of inexperienced managers cannot be used as a rationale for requiring SPPSs to direct investments in local government bonds to ensure security of assets. Moreover, restricting investments in local government bonds impinges directly in the risk profile and the potential return otherwise achievable by the SPPS through alternative investments.

07.1.4 General

Bearing in mind the advantages and disadvantages associated with the prudent man rule and the quantitative approach as discussed in Section B above, the suggestive findings of international studies about these two regulatory approaches, the internationally advocated approach and the characteristics of the local market – it appears that the disadvantages associated with requiring SPPSs to invest all or a portion of its assets in the local market or in local Government securities appear to be more pronounced and limiting the SPPS in achieving its primary objective i.e. to provide the best retirement benefits possible – which if not attained or not optimised would have macroeconomic implications in its own right.

Main arguments regarding the imposition of restrictions requiring investment in the local market are included in Table 3 below.

Table 3: Main arguments regarding the imposition of restrictions requiring investment in the local market

Arguments in favour of the imposition of restrictions requiring investment in the local market	Argument against the imposition of restrictions requiring investments in the local market
Supports the development and expansion of the local stock market – in theory. (This still remains doubtful with respect to the local scenario, given the particularities of the local capital market and the development thereof to date).	There are limited investment opportunities on the local market in view of its size and number of listed instruments.
Money remains in country and thus used to the benefit of the local economy – multiplier effects.	Substantial investments in the local market may artificially inflate the prices of local assets – particularly if response to local capital market remains slow. Thus, there is the risk of over-inflation of prices and increased volatility.
Investments in the local market may contribute towards security and protection of assets.	The performance will be linked to the prosperity of the local economy. Besides that, there may be other investments which provide a better return

[49] op cit, Roldos J. (2004)

Arguments in favour of the imposition of restrictions requiring investment in the local market	Argument against the imposition of restrictions requiring investments in the local market
	given the same or lower level of risks.
The outflow of money would create shocks to the Maltese economy.	If there are commitments of investments in the local market, then - given also the limited investment opportunities available locally - local issuers could issue securities which offer lower levels of return than otherwise would be offered in an efficient and free capital market.
	Any restriction requiring a percentage of assets to be invested in the local market goes against the investment principles adopted in the EU Pensions Directive for voluntary occupational pension schemes, which promotes freedom of investments and require that investments are invested in the best interest of members and beneficiaries and not in the best interest of any market or country. In this regard, the investment managers are the competent people who are in the best position to decide where and how to best allocate investments within a secure and efficient investment framework.
	Over-restrictive investments are incompatible with modern investment techniques as the efficient allocation of capital would not be allowed.
	National investment restrictions would go against the efforts made by the EU for having no restrictions and flows of capital within the EU market.

07.1.5 Other Aspects

The application of the prudent man rule over a restrictive quantitative approach in so far as foreign versus local investments are concerned, appears to be more appropriate given the characteristics of the local capital market. However there are other aspects that need to be also taken into account:

a. whether SPPSs are to be mandatory or voluntary;

b. the risks associated with the prudent man rule;

c. other special risks (including investments in equities, the local property market and emerging markets).

07.1.6 Mandatory vs Voluntary

Where SPPSs are voluntary, these are considered similar to other investment vehicles and there is no real case for regulating them differently than other investment vehicles. The case for prudential regulation in the form of portfolio regulation arises most clearly where SPPSs are mandatory. By removing the freedom of the individual to choose his or her own level of retirement savings, the government takes on a degree of responsibility – although this degree of responsibility is limited depending in turn, by the nature of the government and private sector promises involved[50].

[50] op cit, World Bank (2002), p. 112

In addition, the nature of the SPPSs to be introduced is important for determining whether the proposed SPPSs fall under the EU Pensions Directive or whether they will be covered by Regulations (EEC) 1408/71 and Regulation (EEC) No 574/72. This is important as it influences the regulatory approach in the field of investments of SPPSs' assets. The following comments regarding investments in immoveable property and investments in equities and emerging markets should be read bearing this aspect in mind.

07.1.7 Investment in immovable assets such as property

One common investment by SPPSs often discussed is investment in property. The Actuary recommends the imposition of a maximum limit of how much SPPSs should be allowed to invest in the local property market. The Actuary advised that pension funds typically invest around 10% to 20% of their assets in real estate – this depending on the nature of the fund's liabilities and long-term commitments.

Different approaches are adopted by countries with respect to investment in property. Although no current data was found in this regard, a study carried out by the OECD in 2002/3 (Table 4 refers) showed that countries impose different ceilings on investment in property – ranging from a maximum limit of 50% in Switzerland to total prohibition in Hungary.

Table 4 – Limits on property investments by pension funds in OECD countries

Country	Maximum % of the pension fund assets allowed in real estate
Austria	20%
Belgium	40% - (20% in one single property)
Canada	25% (in real estate and resource. Max. 5% in one individual property)
Czech Republic	Value of one piece of real estate cannot exceed 5% of the fund assets
Denmark	40% (in property and investment-trust holdings)
Finland	40% (in real estate) 70% (in mortgage loans including investments in real estate and buildings)
Germany	25%
Hungary	- Direct investment in real estate is prohibited for Mandatory Pension Funds - 10% in real estate allowed for Voluntary Pension Funds
Korea	15%
Portugal	50% direct or indirect investment in real estate – 45% in direct investment and 10% in a single piece of real estate
Switzerland	50%

Source: - Survey of Investment Regulation of Pension Funds – OECD Secretariat 2002/ 2003

With respect to the position in the UK it seems that the rules on the investment of pension contributions will be relaxed with effect from 6th April 2006 - with the introduction of new pension legislation - which would inter alia allow investment in residential property (buy to let)[51].

[51] The Future of Pensions. Available online: http://www.fool.co.uk/pensions/articles/further.htm. Last accessed 18th May 2005

Many argue that investments in immoveable property provide excellent investment opportunities, particularly given the long term nature of SPPSs – as they add another dimension to asset allocation, enhancing diversification of the portfolio – particularly since real estate returns have a low correlation with the returns on equities and fixed income securities[52].

In Malta exists a notion that the value of property in Malta never goes down[53], particularly given the performance of this sector during the last three decades, with property prices increasing between four to eight times from 1970 – 1995, depending on the type of property with larger properties commanding higher prices[54] (Appendix 7 refers). However, this uprising trend in property prices does not necessarily mean that the local property market is immune from fluctuations. Mr J D Camilleri makes reference to the downturn in prices of property in Malta in the 1960s and 1970s[55].

There are various issues which one needs to consider in this regard, particularly:

a. Property prices in Malta are high compared to wages earned and the issue of affordability is a frequently discussed topic[56];

b. If SPPSs choose to invest directly in local property, particularly given the lack of available securities on the local capital market, then the prices of property could easily become over-inflated, leading to speculation – with the resultant negative economic and social implications such a situation may give rise;

c. Moreover, direct investment in the property market outside of Malta is highly risky, as foreign property markets are more volatile.

Consideration also needs to be made to the current approach adopted by the MFSA regarding direct investments in property by local collective investment schemes (both retail and professional investor funds) and by life insurance companies:

a. Local Retail Collective Investment Schemes are not allowed to invest any of their assets directly in property;

b. Subject to certain restrictions, prudential regulations applicable to life insurance companies do allow property as one of the admissible assets which may be used to cover a life company's solvency requirements. The amount invested in property may however only be taken up to a restricted percentage in the calculation of the margin of solvency. Moreover it is to be noted that property investments by life companies are effected in the name of the life company and not on behalf of the policyholder (as would be the case in pension funds). In addition, the life company is itself subject to prudential requirements ensuring that it is well capitalised to meet its commitments – in contrast a pension fund would not be subject to separate capital requirements, but rather its net asset value is dependent on the performance of its investment assets.

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52 Principal Global Investors, The Case for Real Estate. Available online: http://www.principalglobal.com/pdfs/research/CaseRealEstate2004Jan.pdf Last accessed 10th May 2005

53 In his comments on the White Paper, Mr J D Camilleri raised the point that "Few seem to remember the huge markdown in Maltese property prices in the late 60s/ early 70s, and none of use seem able to visualise that since we are now part of the open economy in the EU, we are not immune from the property cycles that in the past wrought havoc in countries such as the UK, USA, Hong Kong and Japan.

54 Structure Plan for the Maltese Islands - Housing Topic Paper, February 2004.

55 Consultation Process

56 Op cit., Housing Topic Paper (2004)

Further to the above, it is considered that SPPSs should not be allowed to invest directly in immoveable property, at least not at the outset, given the associated high risks. Rather, it is considered that initially a cautious approach is adopted and SPPSs should limit their exposure to the property market indirectly, that is through investment in publicly traded / listed equity and/or fixed income securities of companies engaged in the real estate industry such as property management and property financing companies[57]. This approach is then reviewed again say within five years' time.

07.1.8 Equities vs Bonds and Investments in Emerging Markets

As already discussed in Section 7.0 of this Paper, it is conventional wisdom that equity investments provide higher returns than bonds in the longer term, however these may be riskier than investments in bonds. Similarly, different markets carry different risks – the main distinction that is generally made is between developed markets and other high risk capital markets (often known as emerging markets). The performance of investments in these risk capital markets is more volatile than the performance of investments in developed markets, at times also involving a risk of loss of capital. Excessive exposure to equity and risk capital markets increase the risk profile and impinge on the security of returns achieved by the assets of SPPSs. These two main risk factors are considered very important given the potential social implication these may have on the adequacy of retirement benefits. However, notwithstanding the volatility of equity returns and performance of risk capital markets, an element of these type of investments in a portfolio contributes towards ensuring diversification of the portfolio as well as achieving certain returns.

Further to the above, it is considered that from a social policy perspective, investments in equity investments and investments in risk capital markets should – at least at the crucial initial stages of the introduction of SPPSs – be imposed with the primary aim of limiting excessive exposure in these type of investments, but also providing a certain degree of investment flexibility (as advocated internationally and suggested by the Actuaries). In this regard, it is considered that SPPSs should limit their exposure to the equity market and non-OECD countries (excluding Malta) to 35% and 35% of their assets respectively.

In so far as the restriction regarding investments in non-OECD countries, it is recommended that investment in the local market should not be prohibited – so that investment managers may also avail of any opportunities available locally, provided there are appropriate investment opportunities.

Moreover, it is also recommended that these restrictions are not imposed on the underlying funds in the case a SPPS invests through a Retirement Fund which is a fund of fund, as long as the underlying funds have a demonstrated track record to the satisfaction of the Regulatory Authority.

These investment restrictions are then reviewed again within five years' time.

07.2 The Regulatory Framework Under the Special Funds (Regulations) Act, 2002

Reference is made to the investment principles proposed under the Special Funds (Regulation) Act, 2002 ('SFA') – which advocate an approach based on the prudent man rule, supplemented by certain quantitative restrictions to ensure prudence and diversification, but also allowing flexibility of investments in the hands of investment managers. Moreover, the SFA framework imposes the fit and proper test of competence, integrity and solvency on managers of SPPSs' assets, which is one aspect of the applicable stringent licensing requirements for parties related to SPPSs. The SFA also imposes various governance requirements (e.g. appointment of independent custodian; independence requirements between the parties related to the SPPS). The SFA also requires, amongst other things, the appointment of auditors and in the case of Defined Benefit Schemes the

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[57] Property management company: companies whose business involves providing a range of services primarily for property owners, including: advertising property, checking references of prospective buyers and tenants, arranging for the sale or lease of property, collecting rent etc.. Property financing companies: companies involved in providing bridging or other finance arrangements to borrowers engaged in property development and investment.

appointment of actuaries, which parties are required to carry out regular monitoring and issue various reports on the activities and status of affairs of the SPPS. The SFA also gives the Competent Authority various regulatory and supervisory powers to effectively monitor the activities of SPPSs and their related parties. Appendix 5 provides a brief overview of the SFA framework. This approach addresses the disadvantages of the prudent man rule outlined in Table 1 above, and is based on recommended international regulatory practice[58] and also is in agreement with the advice of the Actuaries.

The current SFA regulations require the adoption of the 'prudent man' principle with respect to the management and investment of assets – this principle is explained to mean as "discharging duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims".

In addition, the SFA regulations specify a number of investment restrictions, which however stop short from being prescriptive as to where the pension scheme may or may not invest. The current rules imposed on investments under the SFA are included in Appendix 6, which include namely:

a. Restrictions ensuring diversification by imposing maximum investment limits in single issuers and single issues by SPPSs. This is in agreement with the Actuarial recommendation, as well as in line with the analysis of the local capital market.

   It is to be noted that however no minimal allocation by asset type (e.g. bonds vs equities), industry sector and geography is included. Moreover, there is no specific restriction regarding investments in local Government bonds. However these are supplemented by an over-riding principle of diversification

b. A maximum 10% limit is imposed on investments in unquoted securities. This limit is considered prudentially justified given the often unmarketability of these type of securities. This is in line with recommendation of the Actuary that the majority of the assets should be invested in marketable instruments. It is also in line with the EU Pensions Directive.

c. No gearing is permissible and no loans can be granted – as these requirements reduce the risk profile of a pension fund. This is in agreement with the Actuary's recommendation as well as the approach advocated by the EU Pensions Directive

d. A self-investment limit (as suggested by the Actuary) has been imposed – which is in line with the Actuary's recommendations. This limit has been set at 5%. This is considered important to avoid the risk of tying the performance of the SPPS with the performance of the employer. In fact this limit was introduced internationally following the Maxwell scandal – and is required by the EU Pensions Directive and advocated by the INPRS guidelines.

e. No limits are imposed with respect to investment in derivatives – as suggested by the Actuaries. The SFA Directives, merely allow investments in derivatives. There is scope to update the regulations re investments in derivatives, maybe by reference to the requirements applicable in this regard in terms of the UCITS Directive for collective investment schemes qualifying as UCITS.

Further to the above, the SFA – which had been enacted with respect to international pension schemes – provides a suitable framework that may be applied to local SPPSs. However the framework may need to be amended to take into account the comments raised above as to whether SPPSs will be mandatory or voluntary, and the comments with reference to investments in property, equities and risk capital markets. Moreover, it is considered that for local SPPSs:

a. the split between industries and specific country should similarly be a matter for the investment manager (who should be the expert in this area) to decide, depending on where he/she can see most value for the particular pension fund under his/her management.

b. moreover, Investment Managers should be required to explain fully the rationale of any investment made, particularly investments in any particular market (including the local market)

[58] In fact The MFSA has taken into account common practices adopted in other jurisdictions in particular EU member countries, the principles set out in the EU Pensions Directive which was issued in June 2003 and the general principles established by the International Network of Pension Regulators and Supervisors ('INPRS') which cover best practice in the area of occupational pension schemes as well as.

or industry, given the risks associated with excessive exposure in any one area. This requirement is already catered for to a certain degree in the Regulations under the SFA – however there is scope of enhancing further this requirement.

07.3 Concluding Comments

SPPSs could possibly play a significant role in the development of the local capital market. However, the development of the local capital market is not dependent solely on SPPSs and SPPSs should not be utilised as a primary tool to develop the local capital market – particularly given the small and narrow nature of the local capital markets and the respective associated risks.

- The response of the local capital market to a potentially increased demand for securities remains uncertain. An increase in assets for investment through the introduction of SPPSs could create an imbalance between the demand and supply of local market securities, - (depending on many factors) - could potentially cause significant distortions, concentration of risk exposures and asset price bubbles[59].

- Moreover, given the characteristics of the local securities market, including lack of investment instruments, and the concentration risks associated with such restrictions, the SPPS may find itself in a situation of not being able to achieve investment returns otherwise attainable through investments in other markets.

Even when the development of local markets is an important policy objective, SPPSs should not be used for this aim to the detriment of sub-optimising the performance of pension funds and the resultant lack of adequacy of retirement benefits. The primary aim of SPPS should be and should remain that of providing the highest level of retirement benefits in a secure manner.

It is acknowledged that allowing SPPSs to invest outside of Malta, leads to capital outflows with their associated macroeconomic implications. However no capital controls are imposed on other institutional investors – such as collective investment schemes and life assurance companies. Moreover, the imposition of capital restrictions may go against EU requirements and Malta's liberalisation policy that has been implemented gradually over the past years.

It is concluded that local SPPSs should be allowed to follow the prudent man principle. In line with modern portfolio management techniques and the investment principles applied internationally and also at EU level for voluntary occupational pension schemes, the investment allocation of assets should be left in the hands of competent investment managers who should be provided with sufficient discretion as to where and how to allocate assets in the best interests of scheme members and beneficiaries and in a manner which is efficient and secure.

However this prudent man approach should be supplemented with a strong regulatory framework based on the principles of care, diversification, prudence and loyalty. The regulatory framework should establish a strong governance operational framework for SPPS. In addition, it is considered that the prudent man rule should be supported by certain quantitative restrictions aimed primarily at ensuring diversification and addressing particular risks. In addition, at the crucial initial stages of introducing SPPSs within the local market, there is scope of imposing maximum investment limits on investments in equities and high risk capital markets as well as prohibiting direct investments in immoveable property – in order to address the special risks associated with these type of investments.

The SFA already provides a suitable framework which can be utilised for the introduction of local SPPSs, subject of course to certain amendments to cater for specific issues associated with the local scenario.

Moreover, the pension structure adopted i.e. whether mandatory or voluntary, may influence the regulatory response in this areas, in so far as investment regulation is concerned in terms of the EU Pensions Directive.

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[59] op cit, Roldos J (2004)

08. Recommendations

Local SPPSs should be required to manage assets under their management in line with the prudent man rule, supported with quantitative restrictions aimed primarily to ensure diversification, limiting exposure in particular issuers and particular companies. However, the investment allocation of the portfolio between industries and specific countries should be left in the discretion of the competent investment manager, who should be required to record fully the rationale of any investment made.

Local SPPSs should also be subject to quantitative restrictions aimed at addressing special and specific risks, as follows:

a. Investments in employer-related assets should be limited to 5% of assets under the management of the SPPS.
b. Granting of loans should be prohibited.
c. Investment in direct property should not be allowed. Rather local SPPSs should be allowed to gain exposure to the property market through investment in equities / bonds issued by companies involved in the property market.
d. Investments in unlisted securities should be limited to 10% of net assets under the management of the SPPSs.

Moreover, at the crucial initial stages of introducing SPPSs within the local market, there is scope – from a social policy perspective - of imposing maximum investment limits on investments in equities and high risk capital markets – in order to address the special risks associated with these type of investments for the protection of citizens in Malta. In this regard, it is recommended that:

a. Investment in equities should be subject to a maximum limit of 35% of net assets under management.
b. Investment in high risk capital markets (which may be defined as including non-OECD countries, provided that investments in Malta are permissible) should be subject to a maximum limit of 30% of net assets under management.
c. These restrictions should be reviewed within 5 years' time. Moreover, it is also recommended that these restrictions are not imposed on the underlying funds in the case a SPPS invests through a Retirement Fund which is a fund of fund, as long as the underlying funds have a demonstrated track record to the satisfaction of the Regulatory Authority.

Local SPPSs should not be required to invest a minimum percentage of its assets in the local market or in local Government securities. Nor should local SPPSs be restricted from investing abroad.

Investment Managers of SPPSs should be subject to strict entry and competence criteria.

It is important to determine whether the local SPPSs will fall under Directive 2003/41 (EEC) or whether it will be subject to the provisions of Regulation (EEC) No 1408/71 and Regulation (EEC) No 574/72, or any other EU Directive. This may influence the regulation of the investment process, in particular the recommendations made from a social policy perspective.

The framework established under the Special Funds (Regulations) Act, 2002 already provides a sound regulatory framework for the regulation of foreign SPPSs, in line with internationally recommended standards. It is recommended that this framework is utilised for the regulation of local SPPSs. In this regard it is recommended that:

a. Any Retirement Funds (for the local or the international market) will be regulated under the Special Funds (Regulations) Act, 2002, subject to the investment restrictions contained therein and in the supporting Directives.
b. From a social policy perspective, the Government requires that SPPSs for citizens of Malta comply with restrictions regarding maximum investments in equities and high risk capital markets through social policy, in order to protect the retirement benefits of its citizens, particularly if SPPSs are to be mandatory. These restrictions would be over and above those

under the SFA. Then the Competent Authority under the SFA registering / licensing these local SPPSs, will require such SPPSs to comply with these restrictions.

c. any voluntary SPPSs aimed at the international market falling under the EU Pensions Directive would continue to be subject to the current framework under the SFA, as may be amended from time to time.

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