The Modernisation of the Pensions Framework: Securing Sustainable Adequacy

Cabinet Committee on Social Policy

Cabinet Committees' Support Unit (OPM)

September 2004

The Modernisation of the Pensions Framework: Securing Sustainable Adequacy

The Need for Change

i. Current pension cohorts effected by decreasing purchasing value of pension benefit

ii. 30s age cohort and below will receive meaningless pension

Need for social adequacy, within a financial sustainable environment, must be safeguarded

- adequacy defined to mean a safety-net that protects against poverty and enables a decent standard of living

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The Underlying Principles of Change

i. New pensions system and the Nation's fiscal strategies cannot be assessed independently of each other

ii. Pensions reform is necessary irrespective of adequacy and sustainability to account for new norms and behaviours

iii. A balancing between PAYG (First Pillar) and Investment Schemes (Second Pillar) is necessary for attaining sustainable adequacy

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iv. Iron-fencing to contributions and expenditure in a Pensions Account within the Consolidated Fund is necessary for better management and transparency

v. The workforce needs to be expanded and marginalised labour stock (females and elderly) needs to be encouraged to become and / or remain part of this stock

vi. Allowing for individual choice to invest in order to attain pension related income over and above that provided for by mandatory pension schemes

vii. Whilst the design of the new pensions framework should be holistic in concept, implementation is to be phased and staggered as appropriate

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The Path to the proposed White Paper

○	March 1998	MCESD R Camilleri commissioned report
○	August 1998	Middle Sea Watson Wyatt Ltd commissioned report

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○	June 2001	NCWR Galdes report
○	October 2003	NCWR Schembri report
○	December 2003	Dalli Guidelines
○	March 2004	World Bank report

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The Challenges

- Aging
- Birth Rates
- Employment Participation
- Changing Gender Roles
- Economic Performance and Wealth
- Financial Sustainability
- Education and Life Long Learning

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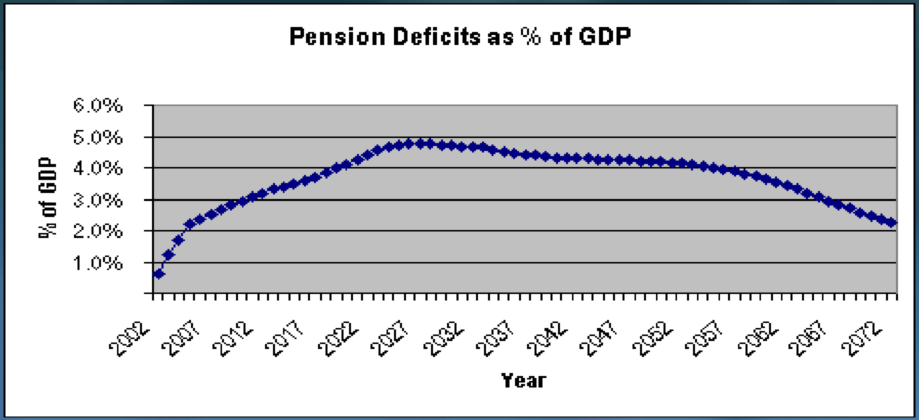

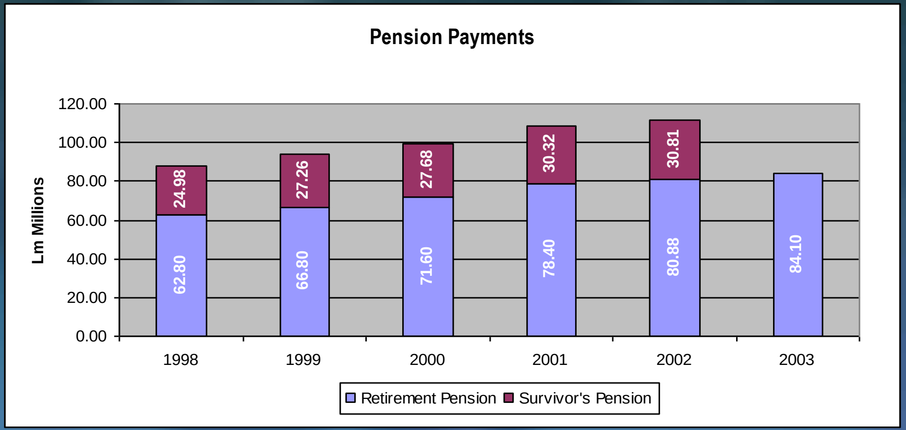

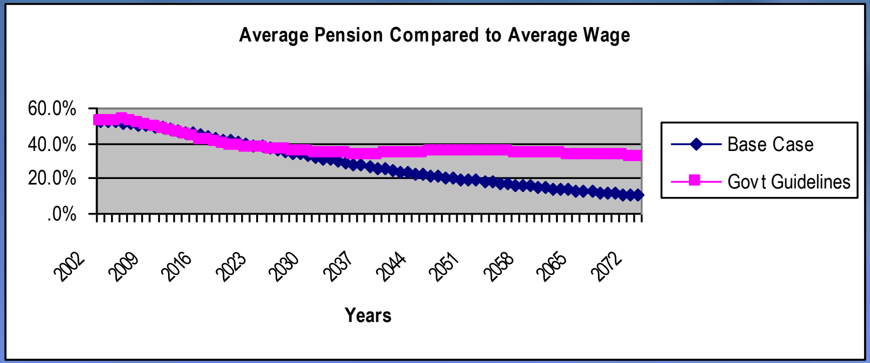

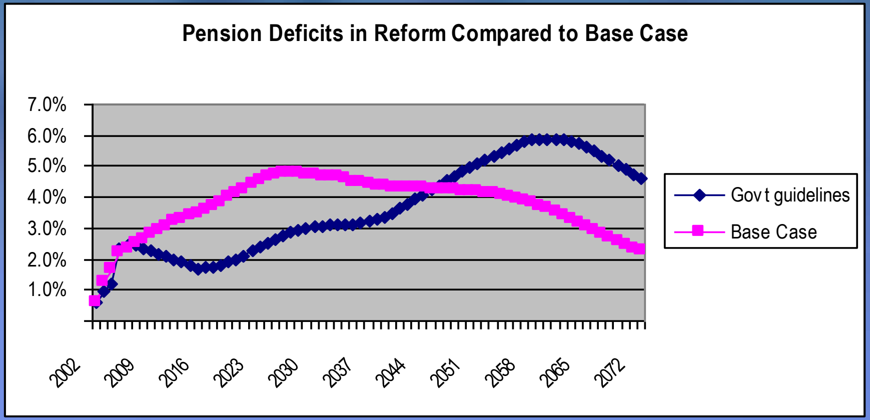

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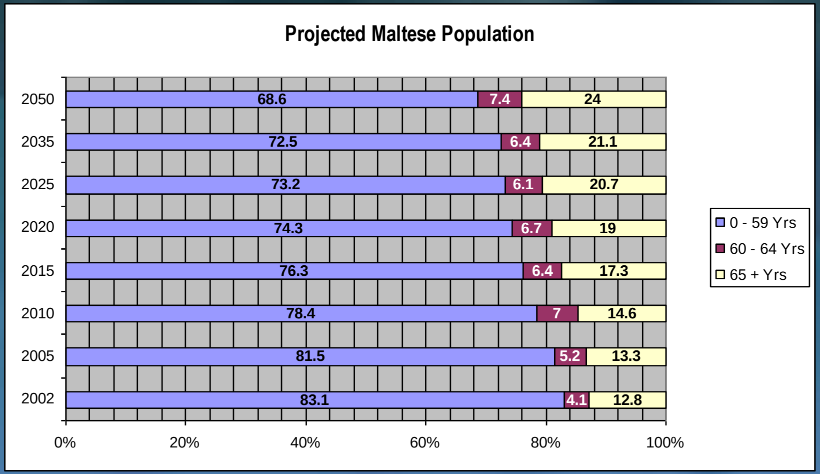

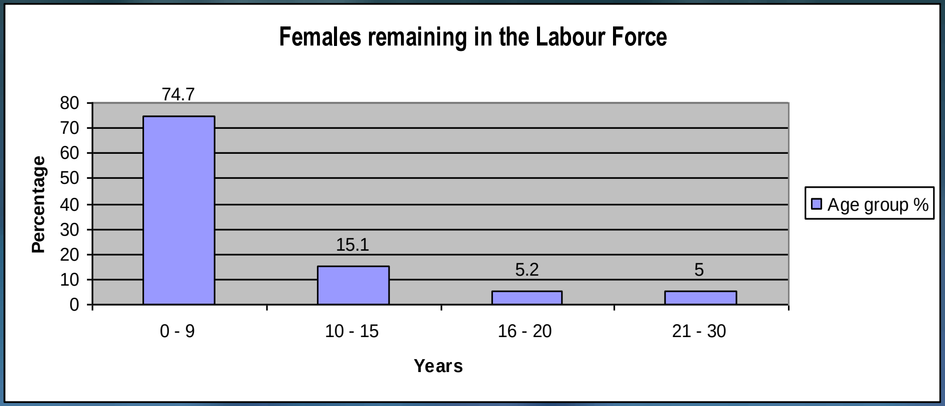

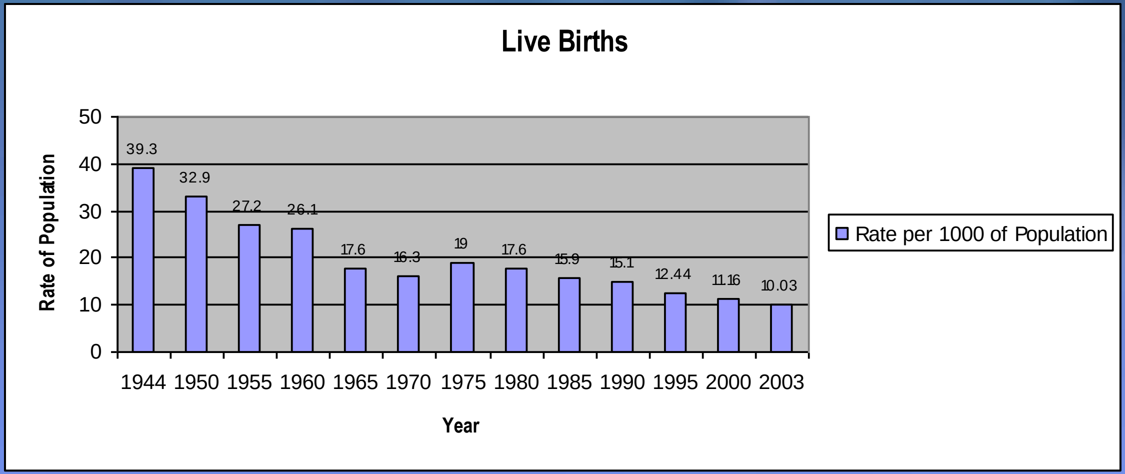

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The Proposed Pensions Framework: The Value System

- Built on EU Gothenburg Council (2001) 10 motivators directed to attain:
  - Adequacy
  - Sustainability
  - Modernisation

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The Proposed Pensions Framework: The Underpinning Principles

- PAYG (First Pillar) – Safeguards Against Poverty
- Mandatory and Flexible Investment (Second Pillar) – Assures Decent Standard of Living
- Voluntary Investment (Third Pillar) – Complements the Safety-Net

Safety-Net

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The New Pensions Framework

The Proposed New Pensions Framework

First Pillar Pension

- Mandatory
- Post Pension Retirement Retail Price Indexed
- Minimum Pension Guarantee indexed to Risk-of-Poverty
- 40 Year Accumulation Contribution Time Based Period (Implemented on a staggered basis)
- Two-Thirds Pension on net income
- Maximum of capped salary base (Lm6,750) Accumulatively Retail Price indexed
- Credits for Life Long Learning
- Two year per child credits for Parental Responsibilities related to Child Bearing and Raising - subject to returning to work
- Employment Income Contributions Base
- Capped Contribution and will increase in proportion to MPI
- Retirement Age Based
- Option for Disincentivised Gradual Retirement

Transparent Pensions Account

Compliance

Secures Against Poverty

PAYG Contribution	
State	9%
Employer	10%
Employee	8%

Second Pillar Pension

- Mandatory by 2010: but introduced voluntary during a transitional period
- Common Yet Flexible Occupational Scheme
- No Opt Out
- Portable
- Tax Free Contributions
- Capped % Income Tax on maturity of fund
- Part to be paid as Lump Sum
- Main to be placed in Annuity to provide annual pension
- Wage Indexed contribution

Secures for Decent Standard of Living

Ex-ante and Ex-post Safeguards

PAYG
Employer 2% (5%)
Employee 2% (5%)
[World Bank recommendations]

Third Pillar Pension

- Voluntary
- Contribution Non -Taxed subject to a Capped Value
- Income Tax on PAYE rate upon maturity

Supplements the Safety-Net

Governed by MFSA Subject to Special Funds (Regulations Act)

Health Fund
1% State Grant
2% Employee

SAFETY - NET

CONTRIBUTOR

Statutory Retirement Age to be 65 years with implementation staggered by age cohorts
Ability to earn uncapped income whilst benefiting from First Pillar pension subject to Payment of Contributions and Income Tax

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Staggered Implementation (i): Statutory Retirement Age

Gender equality for retirement at 61 years reached by 2006

Years of Age as at 1st January 2007	Retirement Age
55 years of age and over	No change from current retirement age
52 years of age to 54 years of age	62 years
49 years of age to 51 years of age	63 years
46 years of age to 48 years of age	64 years
45 years of age and below	65 years

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Staggered Implementation (ii):	Contribution Period for the Accumulation of the First Pillar Pension
Years of Age as at Date of Introduction of this Parametrical Measure	**Accumulation Period**
46 years of age and over	No change from current accumulation period
40 years of age to 45 years of age	35 years but with ability to make voluntary contributions for gaps in employment history
39 years of age and below	40 years

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Staggered Implementation (iii):	Time Based Period for the Calculation of the First Pillar Pension
Years of Age as at Date of this Parametrical Measure	**Base-line for Calculation of First Pillar Pension**
55 years of age and over	No change from current retirement age
50 years of age to 54 years of age	Average of best 5 years
45 years of age to 49 years of age	Average of best 10 years
44 years of age and below	40 years

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Simulation of Impact of Reform: PAYG

	Reform			Current
	inflation rate assumed at:			
	2%	2.5%	2.75%	
Clerk:				
Age 54 in 2004	Lm78.12 wkly	Lm79.81 wkly	Lm80.67 wkly	Lm82.02 wkly
Age 49 in 2004	Lm87.28 wkly	Lm91.21 wkly	Lm93.92 wkly	Lm82.02 wkly
Age 65 in 2025	Lm87.44 wkly	Lm92.34 wkly	Lm94.04 wkly	Lm86.54 wkly
Age 65 in 2045	Lm143.62 wkly			
Assistant Principal:				
Age 54 in 2004	Lm101.07 wkly	Lm103.58 wkly	Lm103.55 wkly	Lm86.54 wkly
Age 49 in 2004	Lm108.55 wkly	Lm108.55 wkly	Lm111.69 wkly	Lm86.54 wkly
Age 65 in 2025	Lm96.58 wkly	Lm98.45 wkly	Lm98.92 wkly	Lm86.54 wkly
Age 65 in 2045	Lm149.47 wkly			

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Issues

i. Econometric, Financial, and Actuarial Modelling yet to be undertaken

Models referred to in White Paper related to models ran in relation to the March World Bank Report

Preliminary Modelling on White Paper carried out by World Bank between 16th to 19th September

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Assumptions:	Macro Economic Variables different from March Report
	Various Pensions Parametrical assumptions run
Base Line Comparison:	Current System
	March World Bank Report cannot be used as base line due to different macro economic assumptions

White Paper should have a Chapter setting out outcome of models used and a Technical Appendix

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Pensions Modelling Parametrical Assumptions

In so far as possible a line in the sand is drawn between ‘old’ and ‘new’ pensions framework. The following are introduced with immediate effect or in a staggered fashion as previously shown:

(a) Retail Price Index on MPI and post retirement pension (immediate)

(b) Statutory retirement age (staggered)

(c) Contribution period for accumulation of First Pillar Pension (staggered)

(d) Time based period for the calculation of the First Pillar Pension (staggered)

(e) Continued employment post statutory retirement age (immediate)

(f) 3% payment to Health Fund

(g) Extension of contribution base-line to employment related income (Model 01)

(h) Establishment of revenue base-line on two thirds of net wage (Model 02)

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Pensions Modelling Parametrical Assumptions (cont…)

Introduced for Persons who will be 45 years of age or younger at the time of the reform

(a) Minimum Pension Guarantee

(b) Extension of contribution base-line to employment related income (Model 02)

(c) Establishment of revenue base-line on two thirds of net wage (Model 02)

(d) Introduction of credits relating to parental responsibilities in relation to Child Bearing and Raising

(e) Introduction of credits in relation to Life Long Learning

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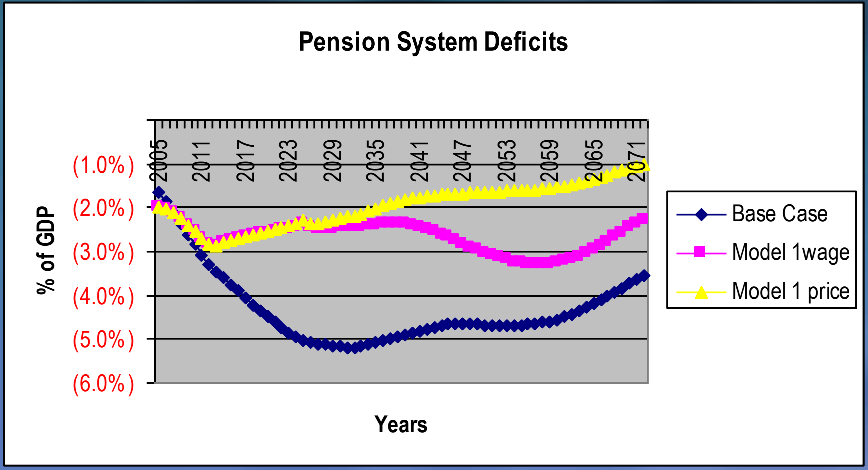
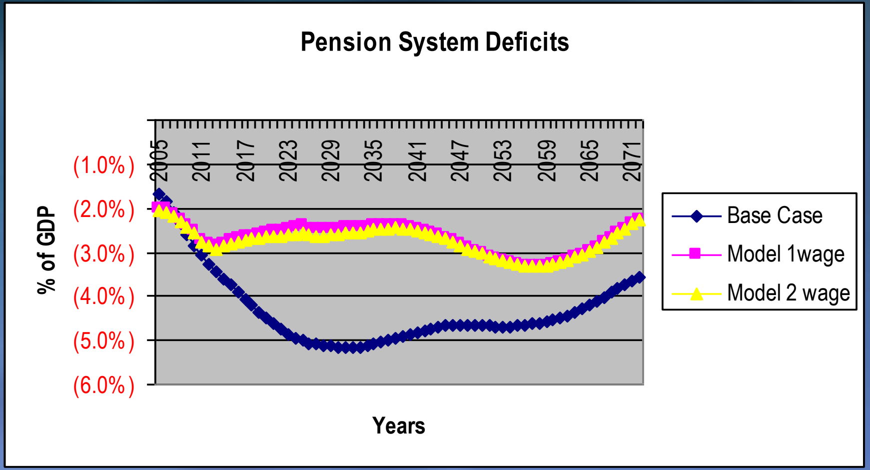
Results (i)





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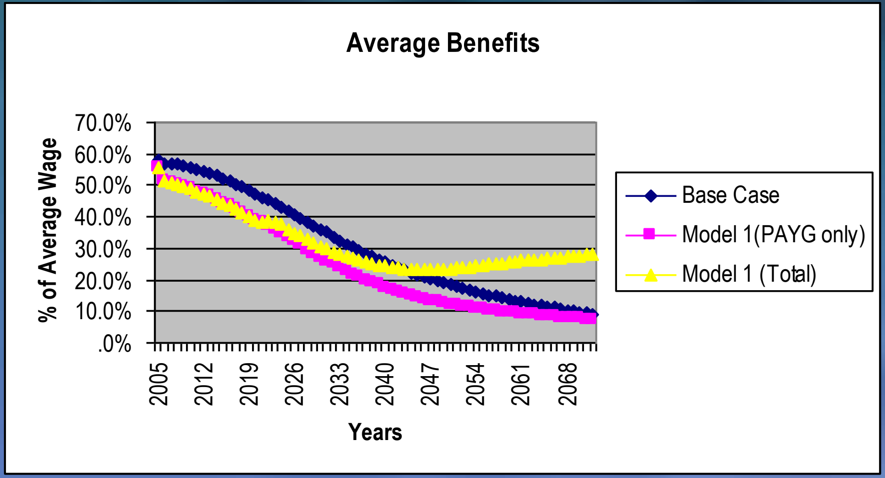
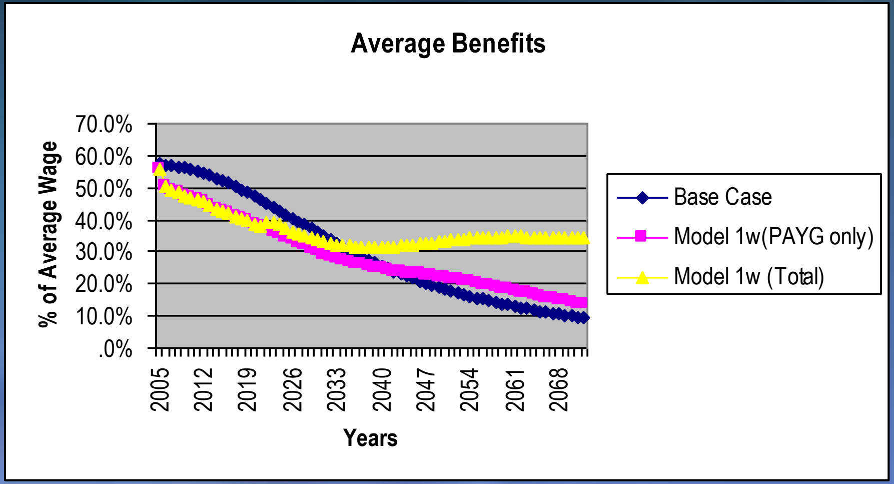
Results (ii)





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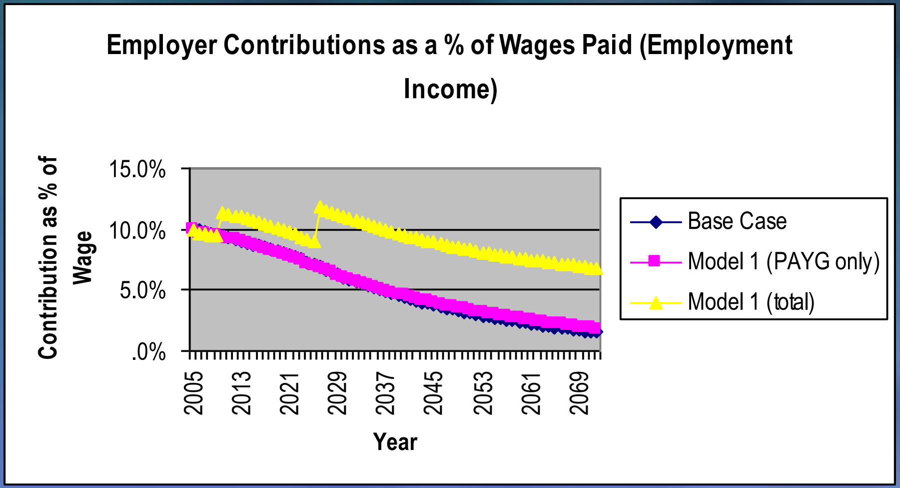
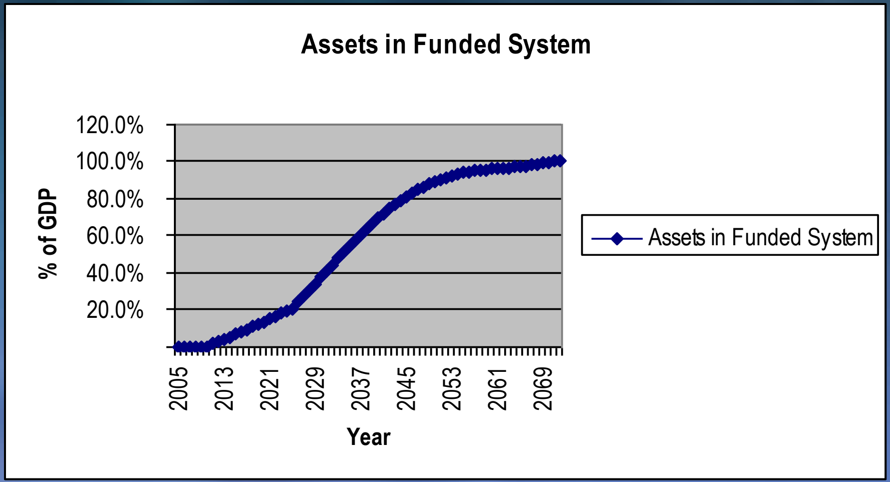
Results (iii)





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ii. Voluntary Second Pillar up to 2010

- Special Funds Act defines that a Scheme cannot be considered as such if it provides for retirement benefits to five or fewer beneficiaries
- MFSA can, however, issue a written notice to allow such schemes to be considered as such
- Private Sector can be mandated, therefore, to provide for Voluntary Schemes if requests are made
- Voluntary Schemes should be designed on the basis of the Mandatory Second Pillar to allow for smooth transition
- Impact on Government Annually as Employer if employees adopt choice of Second Pillar: Lm4.6 million (2% of Lm231,336,000)

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iii. Health Fund

White Paper proposes that NI contributions are channelled to Health Fund and recommends the following from the % contribution for PAYG:

Employer: 0

Employee: 2%

State Grant: 1%

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iv. First Pillar: Premised on safe guarding against Poverty:

- establishment of Minimum Pensions Guarantee that is Risk-of-Poverty Indexed
- automatic annual calibration with Risk-of-Poverty Index

Raises the question whether this should be limited solely to pensions or whether it should be applied to all other social benefits

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v. Potential Social Partners Position on Second Pillar

- Government run with Board of Trustees including social partners; subcontracted for administration to one private sector firm by competitive tendering

  as against White Paper:

  Private Sector run under tight regulation regime already in place through Special Funds (Regulation) Act 2002

  It is to be noted that over time a market approach as proposed in the White Paper will result in a consolidation process over time

- Underwriting by Government for shortfalls

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vi. Model of Second Pillar

World Bank proposes ‘Defined Contributions’ model (2% of salary immediately and 5% of salary by 2020). This model does not guarantee payback, which is market and interest rates dependent

Alternative model is ‘Defined Benefits’ model which establishes return upfront. If market fails to behave as per assumptions (investment risks, longevity risks) Employers and / or Government would need to make up for shortfall if the investment underperforms

‘Defined Benefits’ schemes are seriously underfunded and internationally a migration towards ‘Defined Contributions’ is underway

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vii. Threshold for Second Pillar Contribution

White Paper as it stands assumes that all employees irrespective of income will contribute to mandatory Second Pillar

Such a model will have a negative impact on employees earning lower income levels

Overseas jurisdictions (Australia) exempt minimum earners from Second Pillar contribution. Alternative is that Government subsidises, in part or in full, the Second Pillar contribution of designated income earners

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viii. Indexation

White Paper proposes that:

- post retirement pension
- maximum of salary base (Lm6,750) upon which 2/3 pension is calculated

are indexed to Retail Price Index (the Official Inflation Index) *as against* the Elderly Index to safe guard against decline in purchasing value

Retail Price Index provides a far better mechanism than the Elderly Index to protect against inflation

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ix. Transitional Casualties

The age cohort from 45 years of age (assumed to be subject to mandatory Second Pillar at date of reform) and over may become transitional casualties

May be partially overcome by providing them with the choice to partake in the Second Pillar and potentially the reformed First Pillar

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x. Incentivising Continued Employment Post Statutory Retirement Age

The proposed framework recommends that First and Second Pillar Pensions are frozen if a person continues to work beyond 65 years; with no limit on income earned subject to the continued payment of the PAYG contribution

This is not considered to be sufficient to attract persons to remain in the workforce post retirement

Overseas jurisdictions (U.K.) provide a percentage return to the pensioner on the frozen First Pillar Pension

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xi. Pensions for Members of Parliament

Cabinet Committee for Social Policy is of the conclusion that Government will be discredited if it undertakes a pension reform of this magnitude and fails to reform the current pensions regime for MPs

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xii. Service Pensions, Anomalies, Separation et al

Cabinet Committee for Social Policy is of the conclusion that the White Paper should focus on the major concepts and should make no reference to sectorial issues

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xiii. Social Impact Assessment

First draft prepared by the Management Efficiency Unit (MEU) on Version 2.1 of the White Paper

Negative assessments not surprising though draft is not balanced and tighter editing required. Feedback provided to MEU

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xiv. Managing Expectations and Mobilising Support

Focus must be the ‘citizen’ and message must be successfully delivered across all strata of the population

An aggressive communications strategy is required

Consultation process must be of sufficient time to unequivocally impress that the Government is sincere in seeking national consensus through consultation and discussion on this issue

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xv. Post-White Paper: Considerable Work at a High Tempo Must Follow; including:

- analysis of feedback
- post consultation public report and final position
- economic, financial and actuarial models
- drafting of new legislation
- drafting on Second Pillar policy instrument

High powered focused Technical Team consisting of MEU, MFSS and MFSA and CCSU to be constituted

Executive chair required to sustain and maintain momentum