Introduction of Second and Third Pillar Pensions

Pensions Working Group

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Executive Summary

In drawing up this Report on Second and Third Pillar pensions, the Working Group faced two specific challenges.

The **first** challenge arose from the fact that the Working Group changed the basis of the assumptions upon which previous pension modelling had been carried out. All pension modelling scenarios carried out up to 2006 where based on 2002 data and on a macro-economic assumptions framework established by the World Bank. It is pertinent to add that the global and local economic outlook, at the time at which this macro-economic assumptions framework was carried out, was a positive one that foresaw continued growth – albeit one that slows down over time.

The demographics supporting the pension modelling was also carried out on a different basis. At the time of the previous model the EUROPOP demographic forecast that Malta would have a population of 550,000 by 2050 was rejected. The demographic data applied was that which the Malta Counsel for Economic and Social Development built together with the World Bank and the National Statistics Office in 2002.

The modelling carried out in this report is based on a different macro-economic assumptions framework and demographic model. Given Malta's entry into the European Unit the Working Group was of the considered opinion that the macro-economic assumption framework should be based on that established by the Aging Working Group of the Economic Policy Committee of the European Council. A significant deviation in this framework with that applied for previous modelling is that the GDP growth rate applied is considerably more conservative. Undoubtedly this has a negative impact on the outcome of the adequacy and sustainability pensions system as when compared with results reached in previous modelling.

With regards to the demographic base the Working Group applied the EUROPOP 2008 projections which see a higher population and migration growth than that applied in previous models.

The changes in assumptions and the resulting simulation carried out on a PROST tool that reflected the local pension system following the parametric reforms carried out in 2006 result in a pension deficit of (7.2%) of GDP by 2050 with a pension replacement rate to average wage ratio of 43% by 2050.

The pension replacement rate to average wage ratio of 43% on the First Pillar is significantly higher than that reached in previous modelling which stood at 29.4%. It is pertinent to add that the pension replacement rate to average wage ratio of 38.9 reached in previous models include a replacement rate segment of 9.2% generated through a Mandatory Second Pension Pillar.

An increased pension deficit, under the new assumptions regime, to sustain a far higher pension replacement rate to average wage ratio is not surprising. The result confirms the conclusions of the previous pensions work: that a higher pension replacement rate to average wage ratio that stems **solely** from a First Pension Pillar is not sustainable.

One concludes that parametric change is required within the framework of the First Pension Pillar in order to render this more sustainable. The alternatives are basically two fold. First, either the pension contribution paid to the First Pillar Pension is increased or, second, a mandatory Second Pillar Pension is introduced.

This leads to the second challenge. The economic and financial melt down experienced over the past 18 months brought with it two concerns.

The **first** concern is whether a Second Pension Pillar built on a private pension framework remains, after the experiences of the past 18 months, a viable solution. The Working Team has looked hard at this matter both with regards to studying reports and analysis of the financial crisis as well as policy response to the crisis.

There is no doubt that the financial and economic crisis had two pervasive effects. *First,* it has brought to the fore the unsustainability of defined benefit pension systems. *Second*, persons who have or are turning their pension plan proceeds into income and annuity based pensions will receive a lower contribution than those persons who did so prior to the financial melt down and those that will do so once the economic and financial situation returns to normality.

The Working Group, recognisant of the risks that prevail in defined contribution schemes concludes that the financial and economic crisis, ***of itself***, does not diminish the importance of private pension provision in a well balanced private public pension framework directed to ensure quality of life during retirement.

The Working Group emphasis that a First Pillar Pension that continues to be based on the Pay-As-You-Go principle carries within it inherent risks that will not disappear in a situation where Malta has an aging population and where the indigenous component of the population structure is diminishing. A PAYG pension system is intrinsically intertwined with the demographic behaviour of Malta. As people live more, age more and as there are lesser births the PAYG system, on its own, is not sustainable. Moreover with the indigenous population shrinking due to decreased births the demographic deficit can only be made up by immigration.

Thus, the Working Group is of the considered opinion that a Mandatory Second Pension Pillar that is well designed and balanced is a necessity to, on the one hand, supplement a First Pension Pillar pension replacement rate to average wage ratio that structurally sustainable.

The question which the Working Team grappled with for some time is when should a Mandatory Second Pension Pillar be introduced? The work of the previous working group on pensions in its Final Report had proposed that a Mandatory Second Pillar Pension should be introduced in 2011; with a neutral carve out of the First Pillar Pension brought in 2007. These recommendations were, however, made in an environment where growth was considered to continue given that there were, at the time, no signs that a financial and economic crisis was looming.

This report, however, was prepared within the eye of the storm unleashed by the financial and economic crisis. Its existence and, therefore, the impact of measures that are introduced today whilst consumers and employers alike are struggling with the negative effects of this cyclical phenomenon cannot be blindly avoided.

The knowledge that structural reform is required whilst at the same time trying to limit measures that may result in a deeper and longer recession was a dilemma which the Working Group discussed and agonised over at length.

The conclusion which the Working Group reached is that under current economic conditions the Government should **not** seek to introduce a Mandatory Second Pillar Pension. The reasons are many and are discussed at length in the report.

Nevertheless the Working Group is of the considered opinion that measures should be taken to build a culture for saving for retirement through the introduction of voluntary mechanisms supported by knowledge and education as well as fiscal incentives.

The report recommends five specific voluntary mechanisms that should be introduced. The first relates to the automatic opt-in but with the possibility of opt-out to employees. Whilst it is proposed that this mechanism is targeted towards all employees who were 45 years of age when the retirement age was increased to 65 years it is believed that such a mechanism would have an impact on new entrants into the labour market wherein spending habits would yet still have to be formed.

The second mechanism is re-designing the Children Allowance benefit so that part or in totality – depending on the means of the beneficiaries – is saved in a Child Pensions Account wherein, upon first employment by the account holder, the proceeds in the account are transferred to a Second Pension pillar plan.

The third mechanism is the setting up of voluntary Occupational Retirement Pension Schemes. The fourth mechanism is the introduction of a home equity release scheme that will allow persons, should they wish to do, to liquidate their home capital asset into a supplementary pension income.

Finally, a mechanism that allows holders of insurance products or contracts to lock these for pension savings and roll these over where upon reaching retirement age the proceeds are transformed to pension income under a private pension scheme is also proposed.

The Working Group is recognisant that in a voluntary environment the success for persons to save for their future is, at least in part, highly correlated with the introduction of fiscal incentive schemes. The Working Group was not in a position to design incentive schemes as savings data required to assess the displacement of finance and revenue from taxation was not available.

Nevertheless, the Working Group concludes that a fiscal incentive scheme that sees existing savings in financial institutions today locked into savings for pensions whilst not managing to create 'new' savings would be a success given that Malta is yet to root a culture to save for pensions.

The report presents a series of recommendations that relate to the setting up, governance, and management of a Second Pension Pillar.

As an immediate next step, the Working Group recommends that Government should, at the earliest possible, introduce a Third Pillar pension alternative together with the appropriate supporting fiscal instruments.

A mandatory second pension pillar should be introduced the moment that the economic and financial situation in Malta stabilises and that the fragility of growth would not be placed at risk by such an introduction.

The recommendations proposed are the following:

Recommendation 01

In the event that the definition of Second Pillar Pension, as applied in this document, embraces a 'Voluntary' Second Pillar Pension then Government would need to amend the current definition within the Social Security Act.

Recommendation 02

The Working Group recommends that, following the finalisation of the initial phase of comparing the Aging Working Group assumptions with the Pensions Working Group assumptions carried out in this report, the forthcoming Structured review of pension reform proposed by the Pensions Working Group in November 2006 should include a detailed modelling exercise which re-evaluates the pension reform proposals in the light of the Aging Working Group assumptions. Such an analysis would provide the necessary information to fine-tune and adjust the proposals presented in the November 2006 pension reform document.

Recommendation 03
The Working Group underlines that, whilst the importance of addressing the structural issues of the pensions framework is a matter of pressing national concern, it concludes that further structural reform should be deferred until such time that the appropriate economic conditions – GPD growth, labour productivity, labour growth, etc – are reached so that the prevailing financial and economic conditions will enable a smooth absorption of the arising impacts.

Recommendation 04
The Working Group recommends that Government and Civil Society partners achieve consensus on what constitutes appropriate economic conditions under which further reform of the pensions framework is embarked upon; so that once such conditions are reached such reform can be embarked upon immediately as smoothly as possible.

Recommendation 05
The Working Group concludes that the financial and economic crisis, *of itself*, does not diminish the importance of private pension provision in a well balanced private public pension framework directed to ensure quality of life during retirement, whilst the expected trajectory of replacement rates and the pension deficit to GDP ratio based on Aging Working Group assumptions provide a greater scope for the introduction of a Second Pillar Pension.

Recommendation 06
The Working Group strongly recommends that, until such time that the economy recovers from the current global recession; the Government is to introduce the appropriate environment for a Voluntary Second Pillar Pension framework and a Third Pillar Pension to provide persons with the option and choice to invest for their retirement over and above the First Pillar Pension.

Recommendation 07
The Working Group recommends that the adoption of the recommendations presented in this report with regards to the introduction of a Voluntary Second Pillar Pension framework should be supported by a strong and sustained confidence building strategy together with the appropriate capacity building by Government, the Malta Financial Services Authority and state and non-government consumer protection organisations to secure a sustained information and knowledge campaign with regards to private pension instruments introduced in the market.

Recommendation 08
The Working Group recommends that a 'soft' private pension framework that: - provides for the automatic enrolment within a Voluntary Second Pillar Pension for an employee

who were 45 years and younger at the time the retirement age was increased to 65 years;

- provides him or her with the opportunity to opt out from the Voluntary Second Pension;
- is designed on the basis of the principles proposed in this Report with a target that such a Voluntary Second Pension is launched by 1st September 2010. (to update).

Recommendation 09

The Working Group recommends that persons who were in the 'transitional group' (46 years to 54 years when the retirement age was increased to 65 years) should be given the option to participate in the Voluntary Second Pension should they wish to do so.

Recommendation 10

The Working Group recommends that the Children's Allowance benefits scheme is reformed so that, depending on the means of the parents, a range staggered between 10% to the full said annual benefit is automatically deposited in a Child Pension Account scheme owned by the Department for Social Security and from which, upon first employment by the account holder, the proceeds in the account are transferred to a Second Pension pillar plan. It recommends that this is competitively introduced within financial banks by not later than 1st January 2011.

Recommendation 11

The Working Group recommends that, in order to incentivise accelerated accumulation of capital within the Child Pension Account, contributions of not more than €500 annually per child made by parents and other designated contributors should be subject to tax relief.

Recommendation 12

The Working Group recommends that payment by an employer of contributions to a Second Pension should only occur in the event that the employer voluntarily introduces an Occupational Retirement Pension scheme for the employees of the entity for which he or she is responsible.

Recommendation 13

The representing Union and the employer may agree, as part of the collective bargaining process on a new Collective Agreement, to introduce an Occupational Retirement Pension scheme for the employees within the respective entity; where such scheme would be managed in terms of the parameters agreed in the Collective Agreement subject to the relevant regulatory framework as may be applicable.

Recommendation 14

The Working Group recommends that Second and Third Pillar Pension Schemes are to be established as Autonomous Pension Funds under the Special Funds (Regulation) Act or as Pension Insurance Contracts under the Insurance Business Act.

Recommendation 15

The Working Group recommends that the Malta Financial Services Authority should **not** amend the Special Funds (Regulation) Act to allow for the setting up of Occupational Retirement Pension schemes as a Non-Autonomous Pension Funds.

Recommendation 16

Whilst the Working Group is of the considered opinion that the relevant Special fund Act and Insurance Business Act respectively should not restrict the type of pension instruments upon which an Occupational Retirement Pension scheme is designed, it cautions that employers and employees should be fully recognisant of the resulting limitations that a Defined Benefit Scheme may have on the employer prior to a decision of adopting such a scheme.

Recommendation 17

The Working Group is of the considered opinion that trader and employer representatives, together with professional bodies, should consider introducing Occupational Retirement Pension schemes that would be able to offer to their members (and their respective employees) benefits by ensuring the maximisation of economies of scale in relation to the overheads to administer such schemes.

Recommendation 18

The Working Group, whilst noting that it would be up to the respective employer of an entity employing less than 5 persons to determine the type of Occupational Retirement Pensions it seek to introduce, recommends that the choice of the said scheme should be cost driven.

Recommendation 19

The Working Group recommends that the Malta Financial Service Authority amends the Special Funds (Regulation) Act to remove the exemption that prevents an entity that employs less than five members to set up an Occupational Retirement Pensions Scheme under the said Act.

Recommendation 20
The Working Group recommends that the Malta Financial Services Authority introduces, by 1st January 2011, a scheme based on the principles proposed in this report, that will allow the holder of an insurance contract / product such as a life endowment policy to roll over such a contract upon its maturity until the holder's retirement age wherein it's subsequently locked into a private pension scheme.

Recommendation 21

The Working Group recommends that adoption of a fiscal incentive scheme to spur up-take to the locking of Insurance Contract / Products proceeds into a private pension scheme when a person reaches a retirement on the basis of the following principles:

Maturity Before Retirement Age	On decision to lock the Insurance Contract / Product proceeds on retirement into a private pension plan.
Insurance Contract / Product Locked and Rolled-Over	Contribution until maturity of product on retirement age Tax Free.
Income Generated	Tax Free.
Upon Maturity prior to lock into a Private Pension Plan	Tax Free (The impression that such an instrument is today tax free is not correct as the Insurance Company pays the Government 15% income tax from the proceeds of the instrument prior to surrendering the proceeds to the contract owner.)
Private Pension Plan generated income or annuity	15% on income or annuity generated

Recommendation 22

The Working Group recommends that the provision of a regulated equity release plan as a further option to a person nearing retirement or who has reached retirement to allow him to boost his retirement income without the need to sell his property during his and his spouse's lifetime should be studied for implementation by the Government – with the study, which should be completed by end 2010, to look at:

- whether a specific legal framework would be required and whether any amendments to the law of succession are required.
- the design of a regulatory regime that would ensure the proper conduct of business by entities providing such products as well as securing robust protection of consumers.
- the implication of equity release products in relation to taxation and succession duties

Recommendation 23

The Working Group recommends that, given that Malta is yet to establish instruments for saving for one's retirement let alone building a culture for saving for one's retirement, there is merit that, in building such a culture, Government puts together a comprehensive tool-box that includes tax incentivisation in pensions savings.

Recommendation 24

The Working Group recommends that, within the ambience of the voluntary Second Pillar and Third Pillar pension schemes, in order to stimulate up-take in saving for one's retirement schemes, the tax incentive instrument is to be designed in a manner that is biased towards up-front tax relief instruments as against on the maturity of such pension schemes.

Recommendation 25

The Working Group recommends that, in designing a tax incentive framework for simulating up-take in the voluntary pensions framework proposed in this report, Government should:

(i) Carry out a study on various tax incentive scenarios to model how these will affect government revenue today, consumption behaviour, savings behaviour, income deferred for consumption during retirement age.

(ii) In tandem with the above, and inputting to the above, the carrying out of a lifecycle behavioural study to model behavioural responses to tax incentive frameworks to the pension instruments as well as to gauge the creation of 'new' savings as against the substitution of savings.

The carrying out of this study is to be preceded by securing the appropriate integrity in household and savings data and in the carrying out of a behavioural study to gauge responses to a voluntary private pensions and tax incentives on the basis of a national population sample.

Recommendation 26

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

Recommendation 27

The Working Group recommends that the Department of Industrial and Employee Relations should strive to ensure that the appropriate level of protection to employees from retaliatory actions and threats of retaliation either by the employer or pension plan representative with respect to pension benefits and the exercising of rights under a pension plan is in place.

Recommendation 28

The Working Group recommends that the Department of Industrial and Employee Relations should establish the appropriate safeguards with regards to benefit accrual and vesting rights on the basis of the OECD Implementing Guideline for Core Principle 5: the rights of members and beneficiaries and adequacy of benefits.

Recommendation 29

The Working Group recommends that:

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

Recommendation 30

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

Recommendation 31

The Working Group recommends that pension benefits stemming from the proposed Voluntary Second Pension framework as well as with Third Pillar Pensions should be on the basis of:

- the flexibility to withdraw a maximum of 25% of the accumulated capital (including pro-rated earnings) as a lump sum.
- the mandatory purchase of an 'income generating option' with the remaining 75% of the accumulated capital (including pro-rated earnings).

Recommendation 32
The Working Group recommends that the income generating option that is to be regulated by the appropriate legislative framework is with regards to the: (a) Second Pension (Voluntary) Second Pension Framework benefit payment should preferably be such that it provides for continued benefits to the qualified dependent of the retiree. (b) is with regards to the Third Pillar Pension at the discretion of the benefit scheme and benefit payment that he or she will select.

Recommendation 33
The Working Group recommends that Government study, by 1st September 2010, a determination of the income generating instrument (including annuity schemes) that shall be introduced for the Second Pension.

Recommendation 34
The Working Group recommends that the Government carries out a study, by 1st September 2010, wherein it will present recommendations for the setting up of a protection regime that will safeguard contributors to Second Pillar Pension against matters such as insolvency.

Recommendation 35
The Working Group recommends that Government should carry out a review by June 2010 on the mechanism that Malta is to introduce to ensure that the appropriate administrative cost structure maximises in terms of economies of scale. Such a review would evaluate, amongst others the: - introduction of a fee capping structure; or - establishment of a central agency to act as a clearing house.

Recommendation 36
The Working Group supports the introduction of the investment restrictions rules as a check on the discretionary authority stemming from the 'prudent person principle' in the revised Special Funds Act; and adds that the latitude provided by the EU Pensions Directive in terms of such a restriction should be maximised to the utmost possible.

Recommendation 37

The Working Group recommends that the Government, in discussions that will be undertaken at EU Institutional level on the financial services and pension regulatory framework as a direct result of the 2008 / 2009 economic and financial crisis, should strive to seek a strengthening of qualitative investment criteria and a diminished discretionary authority under the 'prudent person principle' in relation to Second Pillar Pensions including Occupational Retirement Pensions.

Recommendation 38

The Working Group recommends that whilst pension providers should have the necessary latitude to design pension schemes as they deem appropriate, Government should introduce default schemas for all of the schemes proposed in the Voluntary Second Pillar Pension framework that balance high long term rates of returns with the desired risk profile of investors.

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APF	Autonomous Pension Fund
AWG	Ageing Working Group
EPD	Economic Policy Division
ECOFIN	Economic and Financial Affairs Council
MFEI	Ministry of Finance, Economy and Investments
MFSA	Malta Financial Services Authority
MSP	Minister for Social Policy
NSO	National Statistics Office
ORP	Occupational Retirement Pension
PROST	Pension Reform Options Simulation toolkit
PWG	Pensions Working Group
WG	Working Group on Second and Third Pillar Pensions.

Introduction

Chapter 01

01.1 Terms of Reference of the Pensions Working Group

In August 2008 the Minister for Social Policy reconvened the Pensions Working Group. The newly formed group, which will be referred to in this document as the Working Group on Second and Third Pillar Pensions or simply the Working Group (WG) was given the task to deal with the following terms of reference:

- To review as appropriate and submit recommendations to the Ministry for Social Policy on the design of a legislation framework for the introduction of a second and third pillar pension

- To review the recommendations presented in the White Paper and Final Report presented to Government by the then Pensions Working Group (PWG) in 2005 in relation to private pensions.

- To propose recommendations for the introduction of a Second Pillar (2^{nd}) pension scheme.

- To propose recommendations for the introduction of a Third Pillar (3^{rd}) pension scheme.

01.2 The Constitution of the Working Group on Second and Third Pillar Pensions (WG)

The WG is re-constituted as follows:

Chairperson	David Spiteri Gingell Consultant
Members	Professor Joe Bannister Chairman, Malta Financial Services Authority
	Joseph Rapa Director General, Economic Policy Division, Ministry of Finance, Economy and Investments
	Joe Camilleri Director General, Department of Social Security, Ministry for Social Policy
	Remigio Bartolo Private Secretary to the Minister for Social Policy, Ministry for Social Policy
	Mark Musu Director for Strategic Development and International Relations, Department of Social Security, Ministry for Social Policy
	Marianne Scicluna Deputy Director, Pensions Unit, Malta Financial Services Authority.

Ms Charlene Farrugia, Secretariat Officer at the Ministry for Social Policy acted as the Executive Secretary to the Pensions Working Group.

01.3 The Methodology Applied by the Working Group

In preparing this report, the WG applied the following methodology:

01. The updating of the PROST data upon which the modelling supporting the recommendations presented between 2004 to 2006 to Government were based to the most recent data available.

    The calibration of the macro economic recommendations upon which the original modelling of the PWG was based to reflect the assumptions of the Ageing Working Group of Economic Policy Committee (EPC).

02. A review of the impact of the global financial crisis and the extent to which such a crisis impacts the viability of a 2nd and 3rd Pension respectively.

03. A review of the type of 2nd and 3rd private pension instruments that may be considered to be provided.

04. A review of the supplementary papers relating to 2nd and 3rd Pensions respectively to the Final Report presented to Government in 2005 by the then Pensions Working Group.

05. A review of the draft Pensions Bill prepared by MFSA.

The report builds on the above work.

01.4 The Definition of Second and Third Pillar Pensions as Applied by the Working Group in this Report

It is pertinent to define at the outset the meaning of Second and Third Pillar pensions. Most persons associate a Second Pillar Pension with an occupational pension where the employer and employee both contribute to a private pension scheme. Literature refers to Second Pillar Pensions to be either 'voluntary' or 'mandatory'. Voluntary refers to pensions where neither of the parties is obliged to participate in the scheme. Mandatory refers to pensions where both parties are obliged to participate in a scheme by contributing at a defined level normally established by government.

It is to be noted that a 'voluntary' Second Pillar Pension and a Third Pillar Pension are many a time used interchangeably. This is not correct. A Third Pillar, whilst voluntary, is directed to provide a person with different options in the event that he or she decides to save for his or her pension beyond the State pension scheme – referred to as the First Pillar Pension – and any voluntary or mandatory second pillar pension.

The interpretation of Second Pillar Pension and Third Pillar Pension as applied in this report are the following:

Second Pillar Pension	Includes a Voluntary Second Pillar Pension where neither the employer nor the employee is mandated to pay a contribution. Nevertheless the employer is mandated to administer requests submitted by employees who express a wish to contribute to a particular pension scheme. Administration is defined within this context to strictly mean the processing by the employer of the proposed automatic enrolment of an employee with a voluntary pension scheme, the processing of an opt-out by an employee from automatic enrolment, the direct debit payment of the contribution into the pension scheme and related process in matters.

Third Pillar Pension	A pension instrument that an individual may opt into directly with a private pension fund provider.

It is to be noted that the amendments to the Social Security Act in November 2006 defined a Second Pension as follows:

> "Second Pension means the mandatory pension scheme referred to in article 64C."

Article 64C states the following:

> (1) It shall be lawful for the Minister, in concurrence with the Minister responsible for finance, from time to time, to make and when made vary any regulations under this article requiring persons who have not reached pension age and their employers as the case may be, to make contributions into Second Pension funds which provide for the payment of a regular income or other benefits to such persons and, or their dependants after or upon reaching pension age and may in particular by such regulations provide for the rate of contributions payable as well as the method and times when such payments are to be made.
>
> (2) Any sum or other benefit payable by Second Pension funds to which such regulations may refer shall not be considered as Service Pensions for the purposes of this Act.
>
> (3) Second Pension funds shall be funds governed by the Special Funds (Regulation) Act.
>
> (4) No regulation or any amendment thereto or any substitution or revocation thereof, made under this article shall have effect unless it has received the prior approval of the House signified by resolution."

In the event that Government accepts that the definition of Second Pillar Pension, as applied in this document, embraces a 'Voluntary' Second Pillar Pension then the definition within the Social Security Act would have to be amended.

Recommendation 01
In the event that Government accepts that the definition of Second Pillar Pension, as applied in this document, embraces a 'Voluntary' Second Pillar Pension then the definition within the Social Security Act would have to be amended.

01.5 Acknowledgements

The WG thanks all persons that assisted it through the provision of information, discussion of issues and specific studies carried out on its behalf. The WG specifically thanks the staff of the Economic Policy Division (EPD) within the Ministry of Finance, Economy and Investments (MFEI) and of the Policy Unit of MFSA. Ms Marianne Scicluna, Deputy Director of the Pensions Unit within MFSA and Mr Godwin Mifsud, Senior Economist at EPD deserve special mention.

The conclusions of the Report are, however, the views of the WG.

02.1 The Macro-Economic and Demographic Assumptions by the Pensions Working Group

The White Paper and, subsequently, the Final Report of the then PWG was benchmarked against the World Bank report presented to Government in March 2004. The White Paper provides a synthesis of the key findings of the World Bank and the recommendations proposed.

It is to be noted, therefore, that the modelling which the PWG had carried out both when drawing up the White Paper and the Final Report – in both circumstances with the assistance of the World Bank – was based on the following:

01. The data in PROST on which the World Bank carried out its modelling to ensure that a common baseline was secured between the modelling by the World Bank and the PWG.

02. The data base line was established at 2002. Unless otherwise specifically stated in the relevant appendices of both the White Paper and the Final Report this data was retained.

02.2 The Macro-Economic and Demographic Assumptions of the Aging Working Group of the EPC

Subsequent to parametric reforms introduced in November 2006 the work of the PWG was completed. Macro economic modelling with regards to pensions was thereafter carried out by the Economic Policy Division (EPD) of the Ministry of Finance, Economy and Investment. In November 2008 the EPD, with the assistance of experts from the World Bank, carried out economic modelling on pensions for the period 2008 -2060 for the Ageing Working Group (AWG) of the EPC.

The Economic and Financial Affairs (ECOFIN) Council mandated EPC, in February 2006, to update and further deepen its common projection exercise of age-related expenditure projections on the basis of a new population projection provided by Eurostat. On the basis of the population projection (EUROPOP2008) produced by Eurostat, the AWG of the EPC agreed a common set of assumptions and methodologies to make projections for exogenous macroeconomic variables: the labour force (participation, employment and unemployment rates), labour productivity and the real interest rate. GDP was calculated combining these assumptions.

It is to be noted that these macro-economic assumptions differ from those applied by the PWG.

One notes that the differences in the assumptions on the models generated by the PWG and the AWG are significant and thus the need to highlight and describe the major discrepancies in the assumptions underlying projections for important pension indicators in the future. Such an analysis will help to gauge the impact of the introduced changes in assumptions and show the way forward in terms of future pension system modelling requirements

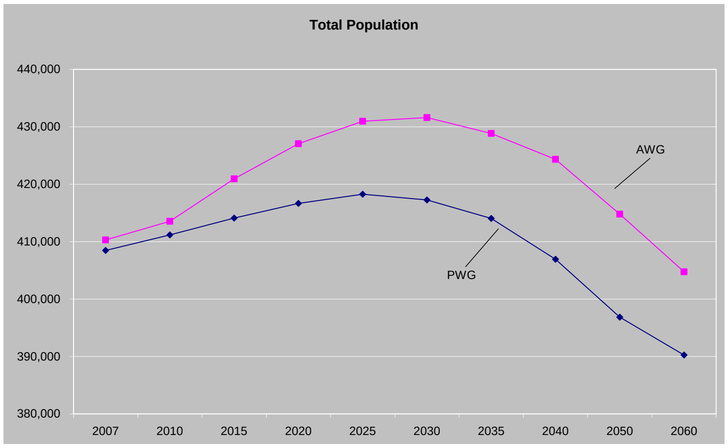
The key impacts are the following:

01. Total Population

Chart 01 below compares the assumptions used by the PWG and the AWG in relation to Population. The PWG applied demographic data that was used by the World Bank in its report of March 2004. This data was obtained from the World Bank through MCESD. This data is consistent with the projections made by the National Statistics Office (NSO). The AWG applied the EUROPOP 2008 population projection.

As can be seen from the **Chart 01** below, the Maltese population growth is smaller under the PWG assumption.

Chart 01: **Total Population**

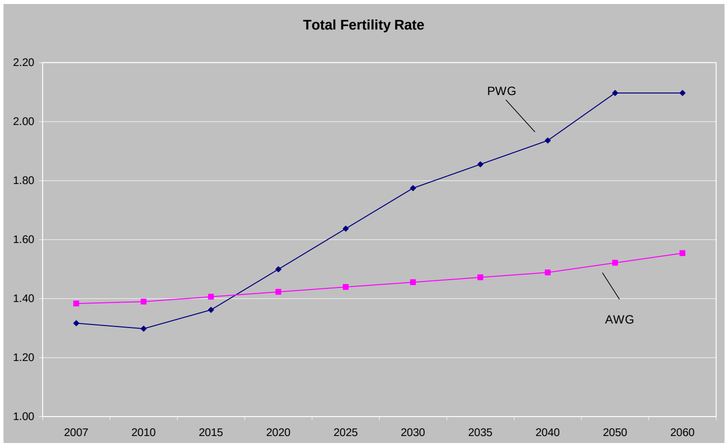


02. Total Fertility Rates

The PWG applied the total fertility rates as estimated in the demographic review by the NSO available at the time the data was inserted in the PROST model: with the data having a 2002 base line. Calibrations were made to the data towards the latter part of the 2004 to 2050 period to account for an increased fertility rate stemming from positive impacts of family friendly measures.

The AWG applied the EUROPOP 2008 fertility rates projection. As can be seen from **Chart 02** below, the assumptions take by the PWG were more positive in that they project a reversal in the decline of the fertility rate from 2017 onwards.

Chart 02: **Total Fertility Rate**



03. Life Expectancy

The PWG applied the life expectancy projections as estimated in the demographic review by the NSO available at the time the data was inserted in the PROST model: with the data having a 2002 base line.

The AWG based its assumptions on the EUROPOP 2008 life expectancy projections. In essence these forecast an increase in life expectancy gains that is higher, not only than the PWG base line, but also than the 2007 Demographic review carried out by NSO.

Table 01: Gains in Life Expectancy

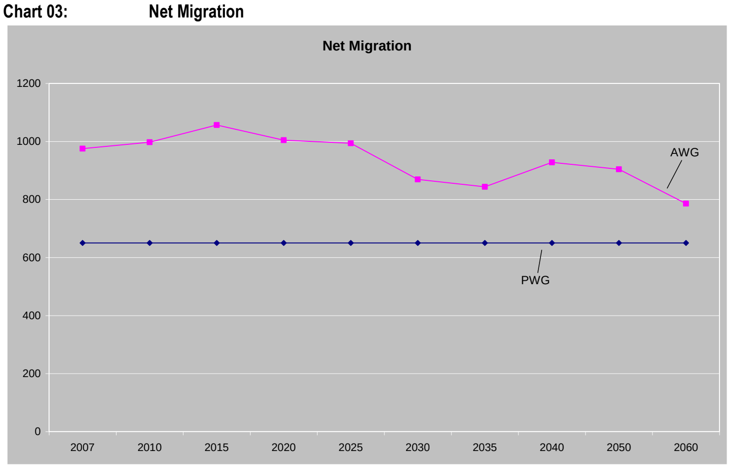
Gains in Life Expectancy: Comparison of various projections (2008 – 2060)		
	Males	Females
EUROPOP 2008	8.1	6.2
PWG Baseline	5.1	4.2
Demographic Review 2007, NSO	4.6	2.1

04. Net Migration

The PWG assumed that the work force would annually increase by the addition of 500 immigrants of which 70% would be in the age cohort of 18 years to 45 years. It further assumed that the workforce would increase annually by the addition of 150 returned migrants.

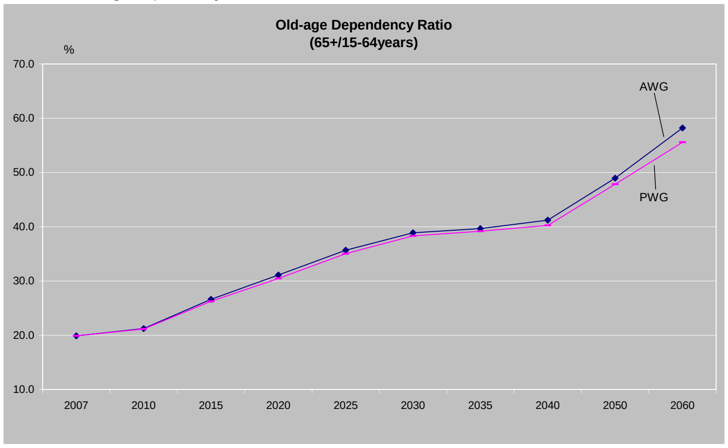
The AWG assumes a higher rate of migration in Malta over the period 2008 to 2060. This is shown in **Chart 03** below.

Chart 03: Net Migration



Although there are substantial differences between the demographic assumptions and data applied by the PWG and the AWG the old age dependency ratio – that is the number of persons working for every pensioner – is consistent. This is shown in **Chart 04** below.

Chart 04: Old Age Dependency Ratio

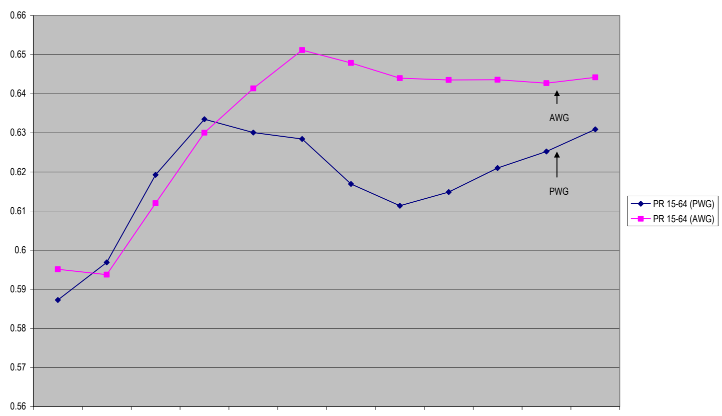


05. Participation Rates

In determining the participation rates, the PWG adopted the projected participation rates as applied by the World Bank in its modelling carried out between October 2003 and March 2004. The PWG amended this data in order to input the latest values as established by the Labour Force Participation Rate as provided by the then Labour Force Survey. The female labour participation rate was projected to increase to 52% by 2020 and 62% by 2050 on the basis that the younger and new generation of female entrants onto the market would have a higher incidence to work.

The AWG assumes that the participation rate for persons between the age of 15 years to 64 years will increase from 59.5% in 2007 to 64.4 in 2060 (64.4% also in 2040). As can be seen in **Chart 05** below, the participation rates applied by the PWG and the AWG behave differently.

Chart 05: Participation Rates

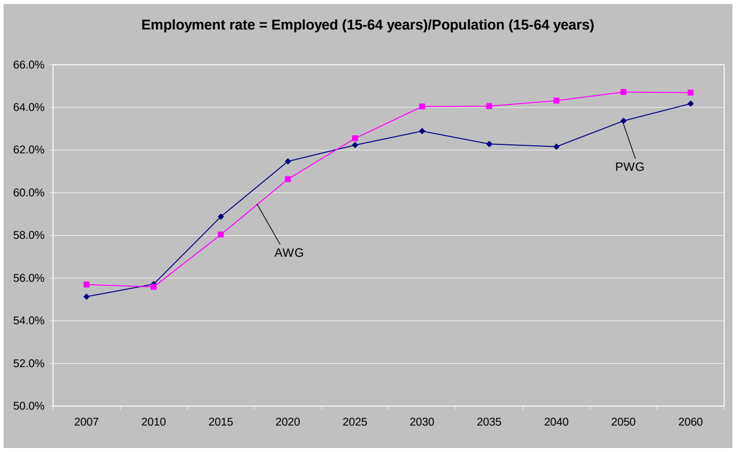


06 Employment Rates

In determining the employment rates, the PWG adopted the projected participation rates as applied by the World Bank in its modelling carried out between October 2003 and March 2004. The AWG assumes that the employment rate for persons between 15 years of age to 64 years of age will increase from 55.8% in 2007 to 64.4% in 2060.

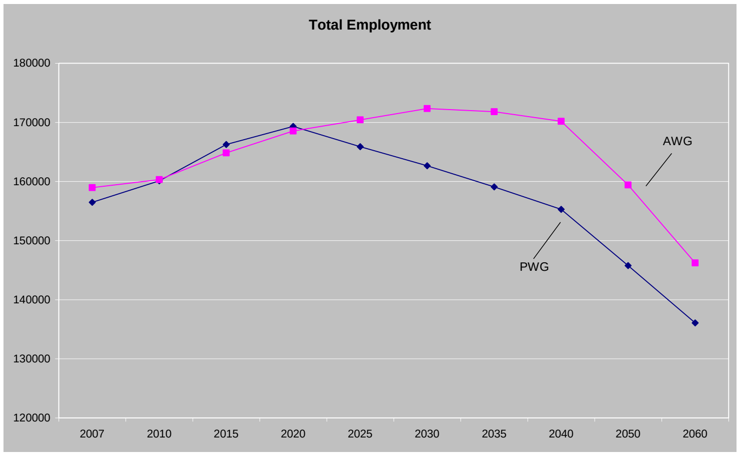
The performance of the assumptions by the two groups is shown in **Chart 06** below.

Chart 06: Employment Rates



The projected employment base by the PWG and AWG respectively is shown in **Chart 07** below.

Chart 07: Employment



07. Inflation

The PWG adopted the NSO released inflation rate for the period 2002 to 2004 and the EPD inflation rate projections for the period 2005 to 2007. For the period 2008 to 2050 the PWG assumed an inflation rate of 2.2%.

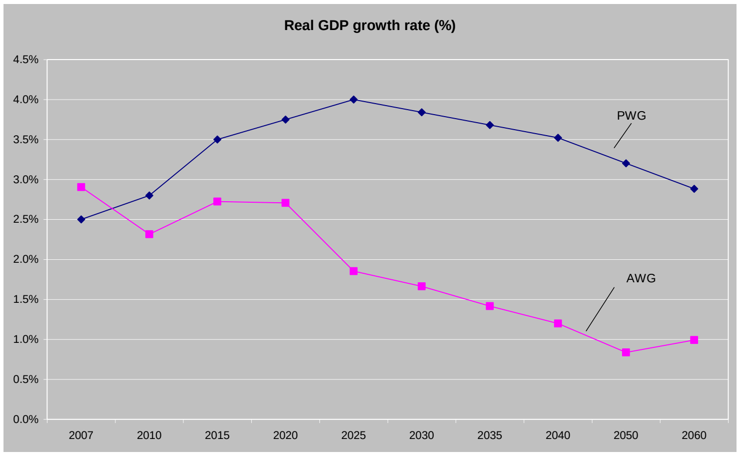
The AWG assumes an inflation rate that would grow from 0.7% in 2007 to 2.0% in 2010 and remains constant thereafter.

08. Real Gross Domestic Product

The PWG adopted the NSO released GDP growth rate for the period 2002 to 2004 and the EPD GDP projected growth rates for the period 2005 to 2011. The PWD subsequently assumed that the GDP would grow incrementally from 3% to 4% between 2012 and 2025 and subsequently grow at a rate of 2.5% for the period 2026 to 2050.

The AWG assumes that the GDP will decrease from 2.9% in 2007 to 2.7% in 2020; and thereafter decrease to 0.8% in 2050 before marginally increasing to 1% in 2060 – an average GDP growth rate of 1.6% over the period 2007 to 2060. **Chart 08** below compares the assumptions taken by the two Groups in this regard.

Chart 08: Real Gross Domestic Product

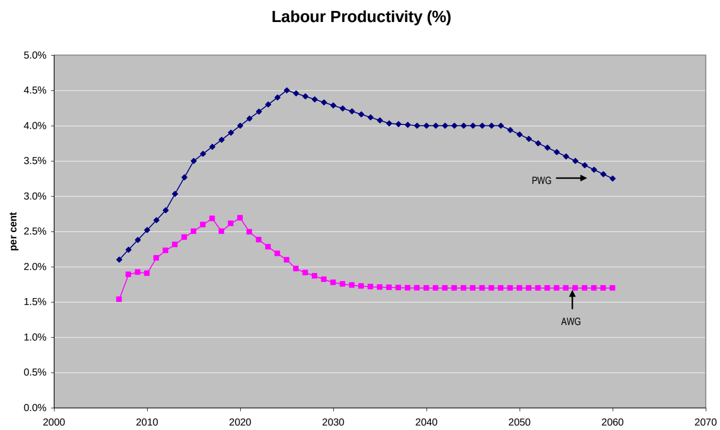


09. Labour Productivity

In determining the productivity rate the PWG applied the data used by the World Bank with the exception that with regards to the productivity growth of minimum wage workers the relevant input sheet within PROST was calibrated to approximate the wage bill to the nominal GDP ratio, in line with the latest published figures.

The AWG assumes a productivity rate that increases from 1.5% in 2007 to approximately 2.75% in 2020 before tailing off to 1.75% in 2030 and decreasing marginally thereafter. **Chart 09** below compares the labour productivity rates applied by the two Groups.

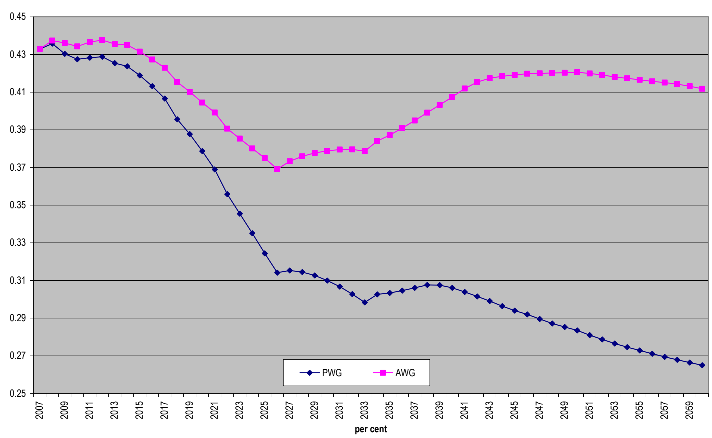
Chart: 09 **Labour Productivity Rate**



02.3 The Impact of the Macro-Economic and Demographic Assumptions of the Ageing Working Group vis-à-vis the Pensions Working Group

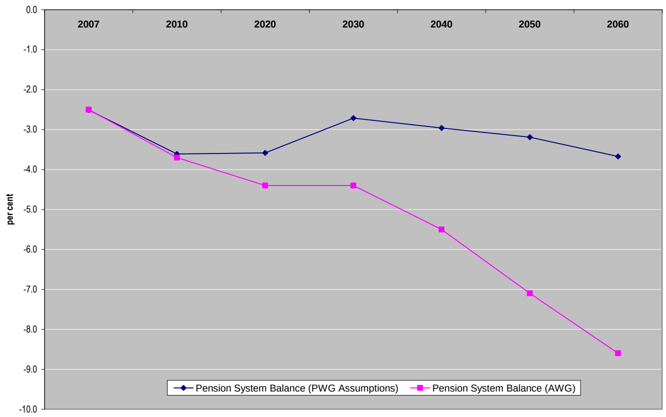
Based on the above analysis, the WG considered it appropriate to re-run PROST using the new AWG assumptions. This section will describe the main divergences in the results, in particular focusing on two very important variables: the average replacement rate and the pension expenditure to GDP ratio. The assumptions taken by the PWG had resulted in an average replacement rate stemming from the reforms of the First Pension Pillar of 29.4% with a pensions deficit of (2.6%) of GDP by 2050.

Chart 10: **Average Replacement Rate**



This is **significantly different** from the results reached on the basis of the AWG assumptions. The AWG achieves a replacement rate of the First Pension Pillar of 42% by 2050 – significantly more adequate than that proposed by the PWG. Nevertheless, as shown in **Chart 11** below, this positive increase in adequacy is at the cost of a far higher pensions deficit with regards to the First Pensions Pillar:

Chart 11: Pensions Deficit



The assumptions upon which the AWG modelling is based lead to a negative pensions balance of slightly over (7.2%) of GDP by 2050.

The difference in the results between the PWG and AWG modelling stems primarily from the different GDP assumptions adopted in the two models. Analysis of the behaviour of the two models indicates that the main reason for the increase in the replacement rate of the First Pension Pillar and the pensions deficit in relation to GDP is the direct result of the parametric measure proposed by the PWG, and adopted by Government, that the Maximum Pensions Income Ceiling of the First Pillar Pension is to be automatically indexed to a mechanism that is constituted of 70% wages : 30% inflation.

It is pertinent to underline that the PWG had also proposed that this instrument would be subject to a 'Control Lever' that would be applied between one Five Year Structured review and the other; where-in the application of such an increase to the Maximum Pensions Income Ceiling would be subject to the performance of the economy and public finances.

There is, however, one other fundamental difference between the work of the PWG and the AWG. The PWG had proposed the introduction of initially, a mandatory, yet 'neutral' Second Pension Pillar between 2007 and 2011 by means of a 1% carve out of the employer's and employee's National Insurance contribution respectively; to be followed by the introduction of a mandatory Second Pillar that would see an increase to an additional 3% contribution by both employer and employee between 2011 and 2025.

The modelling carried out by the PWG in the final report has projected that a mandatory Second Pension Pillar would result in a replacement rate of 9.2% by 2050. In essence, this means that the average replacement rate stemming from the reforms proposed by the PWG - that is, the combination of the parametric changes to the First Pension Pillar and the introduction of a Second Pension Pillar - would be 38.6%.

02.4 Determining the Macro-Economic and Demographic Assumptions Modelling

As shown in this Chapter, the PWG based its macro-economic and demographic assumptions on the data inputted in the PROST modelling carried out by the World Bank upon which its recommendations presented in the March 2004 report were based – with the exception of certain variables introduced by the PWG as described above.

As stated above the AWG modelling is based on a set of assumptions produced on the basis of a commonly-agreed methodology. This approach is based on what may be described as a convergence assumption in terms of demography, which is combined with a cohort method of projecting country-specific participation rates used in turn to project the labour force. The labour force projection is combined with assumptions on structural unemployment and employment rates to generate estimates of total employees over the projection period. The projection of the number of employees is combined with assumptions on total factor productivity and capital deepening is used to produce GDP projections.

As shown in this Chapter the two sets of assumptions lead to considerably different sets of results. A question faced by the WG was whether (a) it should retain the previous PWG assumptions, (b) adopt 'Malta specific' economic and demographic assumptions that take into account the international and local economic and demographic forecasted behaviour; or (c) adopt the AWG assumptions.

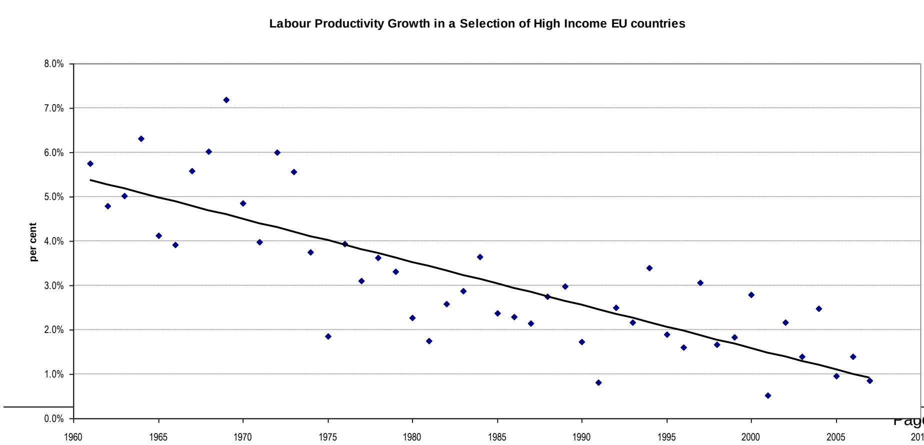
In contemplating Option B the WG assumed two scenarios – which are shown in **Table 02** hereunder:

Table 02: Analysis of Malta Specific Labour Productivity Rate

Scenarios	Labour Productivity	Labour Utilisation	Demographic Factors	GDP
Trend Growth in Labour Productivity and Labour Utilisation	2.0%	0.4%	-0.5%	1.9%
Labour Productivity Growing in Line with 'New Economy': Labour Utilisation Growing in Line with 1981-2007 trend growth	2.3%	0.4%	-0.5%	2.3%

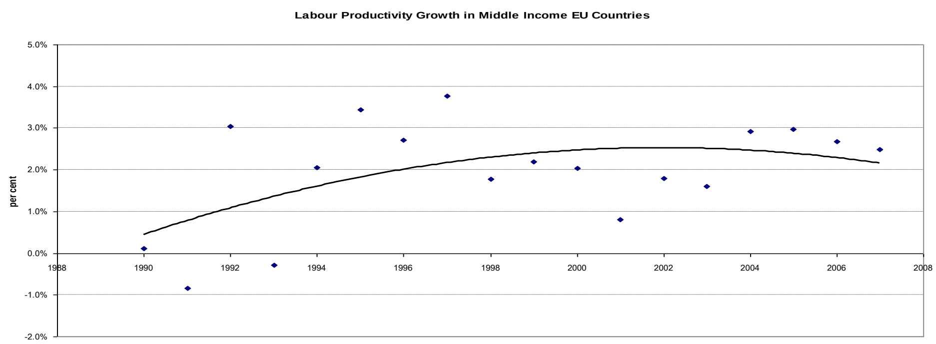
As **Chart 12** below shows that productivity growth in today's high income countries has been on a declining trend over the past four decades.

Chart 12: Labour Productivity Growth in a selection of High Income EU Countries



On the other hand, whilst trends for middle income countries are more unclear, the indications are that labour productivity growth may have reached a plateau.

Chart 13: Labour Productivity Growth in Middle Income EU Countries



The **Table 03** below shows the average labour productivity growth in EU middle income and low income Member States respectively between 1991 and 2007:

Table 03: Average Productivity Growth in the EU: 1991 - 2007

Average Labour Productivity Growth in the EU: 1991-2007 (cont.)			
Middle Income Countries		**Low Income Countries**	
Cyprus	1.8%	Bulgaria	1.5%
Malta	1.7%	Estonia	4.1%
Greece	1.9%	Hungary	2.4%
Portugal	1.8%	Latvia	3.5%
Czech Republic	2.2%	Lithuania	1.8%
Slovenia	3.0%	Poland	4.3%
		Romania	3.4%
		Slovak Republic	4.4%
Average: 1991-2007	2.1%	Average: 1991-2007	3.2%
Average: 2001-2007	2.2%	Average: 2001-2007	5.2%

Note: High Income Countries are defined as countries exceeding 100% of GDP per capita in PPS for EU-27 in 2007

Medium Income Countries are defined as countries where per capita income exceeded 75% but was lower than 100% of GDP per capita in PPS for EU-27 in 2007

Low Income Countries are defined as countries where per capita income was lower than 75% of GDP per capita in PPS for EU-27 in 2007

On the basis of the above the WG concludes that the macro-economic and demographic assumptions for pensions modelling, whether specific to the First Pension Pillar alone, or with regards to both the First and Second Pillar Pensions should be on the basis of:

01. Moving away from the original World Bank assumptions and additional specific assumptions taken by the PWG.

02. Consider the assumptions of the AWG to provide a reasonable benchmark as regards the potential developments of demographic and macroeconomic assumptions over the longer term.

As a result of the analysis carried out in this chapter and as a subsequent step to the work presented above the WG recommends that the forthcoming structured review of pension reform proposed by the PWG in November 2006 should include a detailed modelling exercise which re-evaluates the pension reform proposals in the light of the AWG assumptions.

Such an analysis would provide the necessary information to fine-tune and adjust the proposals presented in the November 2006 pension reform document.

Recommendation 02

The Working Group recommends that, following the finalisation of the initial phase of comparing the Aging Working Group assumptions to the Pensions Working Group assumptions carried out in this report, the forthcoming structured review of pension reform proposed by the Pensions Working Group in November 2006 should include a detailed modelling exercise which re-evaluates the pension reform proposals in the light of the Aging Working Group assumptions. Such an analysis would provide the necessary information to fine-tune and adjust the proposals presented in the November 2006 pension reform document.

03.1 Introduction

This Chapter will seek to discuss two matters. First it will seek to assess the economic impact of an introduction of a mandatory Second Pillar Pension. This discussion is believed to be of importance given that the PWG had recommended that a mandatory Second Pillar Pension should be introduced by no later than 2010.

Whilst as it is clearly shown in the preceding Chapter that the competing pressures of sustainability and adequacy with regards to tomorrow's generations' pensions continue to prevail the decision on the introduction of a mandatory Second Pension must also be based on a clear understanding of whether the current economic state of play within the current cyclical global as well as local economic recession constitutes an appropriate time to introduce a mandatory Second Pillar Pension.

This Chapter will also seek to assess the impact of the international economic crisis on private pensions. The introduction of a mandatory Second Pillar Pension can only be successful if individuals believe that their savings, in the midst of the current as well as potential future economic behaviour, will indeed be secure and provide the necessary savings to be enjoyed during retirement age as a means to safeguard the quality of life they enjoyed during their working life. The implementation of a mandatory Second Pillar Pension amidst a perceived, if not real, fear that a mandatory Second Pillar Pension is not the right instrument required to safeguard a person's savings for retirement will render the process of implementing a mandatory Second Pillar Pension, difficult as it is, so much harder.

03.2 The Economic Impact of a Mandatory Second Pillar Pension

In order to provide an economic assessment of the introduction of a mandatory Second Pillar Pension in Malta it is important to identify the characteristics of such a pension system.

The departure point of the WG, in this regard, is the recommendations submitted by the PWG in its Final Report. The key recommendations that were presented by the PWG are the following:

Recommendation	
No 59	Managing Benefits Upon Maturity of a Second Pillar Pension Scheme
	Upon maturity the pension should provide for 20% as a maximum that can be converted into a lump sum and 80% as a minimum that will be converted into a monthly annuity.
No 61	Implementing the Second Pillar Pension Scheme
	The neutral introduction of a mandatory Second Pension by means of 'carving' out' 1% Employer and 1% Employee from Class I contribution and 1% Self-employed from Class II contribution with effect from 1st January 2007 [which means that the contribution paid on the First Pension will be 9% by the Employer and Employee respectively as well as by the Self-employed].
No 63	Implementing the Second Pillar Pension Scheme

	Contribution to mandatory Second Pension will incrementally increase as follows: 2011: +1% employers+1% employees+1% self employed 2020: +1% employers+1% employees+1% self employed 2025: +1% employers+1% employees+1% self employed
No 64	A Maximum Salary Limit of €35,000 (Lm15,000) is established as the ceiling for mandatory contributions to the Second Pension.

The introduction of the above mandatory Second Pillar Pension as proposed by the Final Report of the PWG would likely have the following economic impacts.

03.2.1 Private Savings and Disposable Income

Official data on the savings ratio in Malta, unfortunately, is rather limited and mostly out of date. It is pertinent to underline that the WG met with the National Statistics Office (NSO) on this matter to determine whether savings data captured in the latest Household Budgetary Survey can be made available to it. It transpires that the NSO is currently reviewing the methodology for the determination of savings in order to bring it in line with Eurostat methodology and this work is not expected to be completed before early this year.

The need for a study to determine the impact of the introduction of a mandatory second pillar scheme on various types of households stratified in accordance with earnings and consumption profiles will have to be carried out once this data is placed in the public domain.

Given such data limitations it was considered appropriate to make use of other 'proxy' variables to gauge the development of saving patterns over the recent years. In particular, one can mention the level and development of 'residential deposits'. Furthermore, one has to review such data in the light of important one-off circumstances which influence activity within an economy. A case in point is the fact that on 1st January 2008 Malta changed over to the Euro and this had an impact on published monetary data.

The annual rate of growth of residential deposits with an agreed maturity of up two years decelerated substantially – falling to 4.3%, from the exceptionally rapid 27.1% growth rate of 2007.[1]

Despite increasing substantially in absolute terms, growth in total residents' deposits decelerated throughout 2008; falling from a peak of 21.1% in January 2008 to 2.8% in December 2008. The Central Bank of Malta explains the increase in deposits as part of the build-up ahead of the Euro currency change over; where thereafter by the end of the 2008 the annual rate of deposit growth returned to levels observed prior to 2007.[2]

On the other hand, during 2008, credit to residents continued to expand – with growth accelerating to 11.8% from 10.8%. The total loans to households and individuals stood at €2.8 billion – constituting 39.77% of the total loans. Growth in such loans constitutes an increase of €278m over 2007. The Central Bank of Malta concludes that "growth in mortgages remained the dominant purpose for bank borrowing by residents, with its contribution to overall private sector credit growth standing at 34%"[3].

[1] Pg 28, Forty-First Annual Report and Statement of Accounts, Central Bank of Malta, 2008
[2] Ibid
[3] Pg 30, ibid

The ‘proxy’ variable data used in this analysis leads one to conclude that there has been no positive significant change in behaviour in relation to savings and that credit sought by households in a considerable part is now directed towards mortgages. In essence this means, that to a large degree, a considerable component of the Maltese population substitutes savings in deposits with investment in property.

It is pertinent to conclude, therefore, that the danger exists that a significant cohort of the Maltese population will have a high non-monetary investment in a property, and potentially the land upon which it is built, but very little liquid investment to ensure that such persons would be in a position to maintain the quality of life they enjoyed prior to retirement.

The position, therefore, remains unchanged from that identified by the PWG. In part, concerned by the fact that Maltese were not saving in liquid financial instruments and the resulting negative impact this would have on the life style of persons when they retire – as well as the economy generally considering that by 2050 36.3% of the population would be 60 years and over and thereby resulting in a significant potential deceleration in spending power by more than one third of the population – the PWG had proposed that Government introduces a mandatory Second Pillar Pension.

In this regard, therefore, one of the primary goals for the introduction of a mandatory Second Pillar Pension is to induce an individual to raise his or her saving capacity over and above that which he or she undertakes on a voluntary basis – or as ‘invested’ in a mortgage. Thus, a mandatory Second Pillar Pension constitutes the deferral of income, and potentially, consumption from the current stage of the person’s life cycle to when the person reaches retirement age.

A mandatory Second Pillar Pension, therefore, has two direct impacts. First, it ‘forces’ a person to save for his retirement irrespective of his or her desire to do so. The PWG had proposed a 1% (carved out from the NI contribution) + 3% additional contributions to be introduced by 2025. In real terms, the implementation of this recommendation would have the effect shown in **Table 04** below in terms of a person’s € purchasing power deferred annually from his current life cycle stage to his or her retirement phase.

Income	1% carve out from Maximum Ceiling 2010 Neutral	+1% 2011 on Max €35,000	+1% 2020 on Max €35,000	+1% 2025 on Max €35,000	Total by 2025
€	€	€	€	€	€
50,000	174.75	350	350	350	1,050
35,000	174.75	350	350	350	1,050
24,000	174.75	240	240	240	720
16,000	159.8	160	160	160	480
10,500	105	105	105	105	315

In essence, therefore, had the recommendations as proposed by the PWG to be introduced today, a person, depending on his income, would in 2011 have to invest a maximum of €350 annually in a Second Pillar Pension.

Second, it is to be noted that a contribution paid by an individual into his Second Pillar Pension is directly routed within a scheme for an individual - unlike the contribution he pays on the National Insurance where such contribution goes into the Consolidated Fund.

It is argued that the setting of a mandatory savings rate at a higher level than a voluntary savings rate that would result in an increase in the aggregate level of savings which would otherwise not have occurred without such an intervention. This is based on the conclusion that if a mandatory contributions rate is fixed at only a few percent, it has been found that individuals may seek to offset their contributions by reducing other forms of savings and increasing debt – rendering the overall impact on aggregate savings negligible.[4]

A Reserve Bank of Australia study (2004) found that in Australia only part of the compulsory superannuation contributions was offset by a reduction in other savings – suggesting that other things being equal – a compulsory superannuation resulted in higher levels of household savings. The study estimated 38 cents of each dollar in superannuation contributions were offset, or in other words, 62 Australian cents in a dollar had been additionally saved. Nevertheless, the study also showed that the additional savings rate varied across different income groups – showing that those earning higher incomes are more able to reduce other savings or borrow more while those reliant on lower income were unable to increase borrowing because of credit constraints.[5]

03.2.2 National Savings

From a macroeconomic perspective, Malta's gross national savings represents the extent to which, in any given year, Malta does not consume that year's GNI, but saves it either via investment in Malta or through the acquisition of a claim on the rest of the world. National savings is derived as the sum of the household sector saving, corporate sector savings and general government savings. Developments in national savings thus have important implications for wealth creation in an economy both over the medium and long term.

03.2.3 National Fiscal Balance

The introduction of a mandatory Second Pillar Pension will negatively impact the National Fiscal Balance in a number of ways.

First, as stated earlier, the contribution paid by an individual for his or her First Pillar Pension is accounted by Government as revenue in the Consolidated Fund. It is pertinent to underline that, for purposes of determining a pensions' system deficit, the World Bank recommends that the State's contribution should be excluded.[6]

Pension accounting in relation to Government, however, changes fundamentally once a Second Pillar Pension scheme is introduced. Under the provisions of the Special Funds Act the contributions paid by both the employee and the employer (in this case Government) are to be strictly separated from the employer – where the contributions paid by both parties would be placed in an 'ironclad' ring fenced appropriate Pensions Fund.

In a scenario where a mandatory Second Pillar Pension is introduced, the introduction of such a Pension Pillar Scheme will have a negative impact on the national fiscal balance as the additional contribution to be paid by the State as an employer would be accounted for in the Second Pillar Pension fund and not within the Consolidated Fund.

Moreover, the implementation of the recommendation of the PWG, where it had proposed that 1% of the National Insurance contribution is to be 'carved out' to allow for the neutral introduction of a mandatory Second Pension Pillar in the short-term, would result in a decrease in Government revenue by the amount hived-off given that this portion of the National Insurance contribution would now be lodged within

[4] Pg 11, The Economic Impact of Mandatory Pensions, Final Report, Fitzpatrick Associates, June 2006
[5] Ibid
[6] 2.06(i), The Maltese Pensions System: An Analysis of the Current System and Options for Reform, World Bank, March 2004

the Second Pillar Pension fund. In 2006, the PWG had estimated the financial impact to Government in 2007 as a result of this recommendation to be €22.37m.[7]

It is pertinent to add that Government, in order to meet the financial costs relating to implementing the recommendations relating to the 1% 'carve out' from the National Insurance contribution and the additional 1% Employer contribution on the mandatory Second Pension, would either have to:

- lower its productive investment programme – and thus effect growth;
- raise taxes – and thus negatively impact the income related multiplier effect as well as return on investment and attractiveness to invest by companies or sole traders;
- raise revenue through increasing its debt portfolio – and further burden future generations, not only with the payment of the Pay-As-You-Go (PAYG) pension deficit, but also with the financing of the contribution to the Second Pillar Pension; as well increasing further the burden on Government's annual fiscal balances due to increased interest payment.

Whatever option is selected, the net effect on the economy would be negative.

The second relates to whether Government is to introduce fiscal benefits to offset in part the cost of savings by a person in a mandatory Second Pillar Pension. To determine this effect the WG, with the assistance of the Malta Financial Services Authority, had commissioned Hewitt Bacon and Woodrow Ltd to simulate a number of incentive scenarios to determine the potential fiscal impact on Government in terms of foregone and deferred taxation[8]:

The scenarios modelled were the following:

Incentive Scenario 1 - Contributions Exempt - Taxed Lump Sump	This structure represents the most commonly employed incentive structure for retirement saving. The incentive is given up front, with tax relief given on both contributions in the mandatory Second Pension Pillar, along with income and capital gains on investment returns. The tax relief given is applied at the member's marginal tax rate, and so provides a greater incentive for persons with higher incomes. The taxation is mostly recouped upon retirement, with the person's pension income being taxed.
Incentive Scenario 2 - Contributions taxed with €2.33 for €9.32 subsidy - Tax-free lump sum	An alternative to Scenario 1 is directed to provide a greater incentive to people receiving a lower income to save for retirement. This 1:4 ratio would provide a subsidy to those persons who might not receive an incentive under Scenario 1. Under this scenario no tax is payable on the lump sum if taken on retirement.
Incentive Scenario 3 - Contributions taxed with €2.33 for €9.32 subsidy - Taxed lump sum	This is a variation of Scenario 2, but with tax payable on the lump sum if it is taken on retirement.

[7] Pg 7, Memorandum to Chairman, Cabinet Committee for Social Policy from Chairman, Pensions Working Group, Amendments to the Social Security Act (Pensions Reform), 15th June 2006
[8] Pg 10, Second and Third Pillar Pension Schemes, Potential Fiscal Incentives, Hewitt Bacon and Woodrow Ltd, June 2006

Incentive Scenario 4	This is a variation on Scenario 1, but with no tax payable on the lump sum if it is taken on retirement.
- Contributions Exempt - Tax-free Lump Sump	

The modelling carried out is based on a number of assumptions which include (a) generation of results based on contributions and not benefits due to the considerable time required before benefits from the mandatory Second Pillar Pension would come into payment and hence the large uncertainty of the level of any benefits by that time – thus the modelling does not show the full extent of the tax received on the payment of benefits; and (b) the macro economic projections are based on a 4% contribution to the Second Pillar being reached voluntary from the outset and not in 2025 when the full 4% is mandatorily introduced.

More importantly, and perhaps the key limiting factor, is that it assumes a 1:4 saving income ration. The study fails to underline why a 1:4 ratio is the most appropriate incentive – and economically as well as financially positive mechanism. The selection of the 1:4 ratio is, unfortunately, arbitrary – which in turn limits the usefulness of the study.

Table 05 below depicts the results of the macro economic projections carried out on the identified scenarios by Hewitt Bacon and Woodrow Ltd.

Table 05: Macro Economic Projections

Macro Economic Projections					
Projection Year	Total Salaries euro M	Income Tax (before contribution incentive) euro M	Voluntary Second Pension Contribution / yr euro M	Cost of Contribution Incentive: Models 1 & 4 Tax relief euro M	Cost of Contribution Incentive: Models 2 & 3 Subsidy euro M
2009	2.90551	230.67	116.5	23.3	27.96
2010	3.09657	244.65	123.49	25.63	13
2020	5.48715	440.37	219.02	46.6	24
2030	8.81672	717.64	351.83	74.56	38
2040	14.31552	1155.68	573.18	121.16	61

The study identified that the cost of providing the incentive in the first year of the Second Pension Pillar would be in the range of €3.5m to €8.2m.[9]

The third impact on the national fiscal balance would be the loss of revenue to Government stemming from the loss of VAT as income is directed towards differed savings as against, at least in part, consumption.

[9] Pg 18, Ibid

03.2.4 Employment Market and Competitivity

The implementation of a Second Pillar Pension will result in an increase in the contribution paid by the employer as well as that by the employee. An immediate economic impact is that this will increase the cost of labour. The consequences can be various.

First, the mandatory contribution that will be paid by the employee may result in demands for an increase in wages; and potentially in the Cost of Living Allowance.

Second, the cost of labour to the employer will, as a minimum, increase by the new mandatory contribution that the employer will have to pay on behalf of his or her staff. This may result in the employer passing on the increase to consumers – with the corresponding inflationary effect – primarily where the employer's market is domestic.

Alternatively, and third, in those circumstances where the employer's market is export or service oriented (tourism) it will impact the employer's price competitiveness – which is determined by productivity, profit margins, and input prices which include real wages. A mandatory Second Pillar Pension, therefore, will increase the employer's cost of production and in doing so directly impact his or her ability to compete – or to retain Malta's competitive edge in relation to Foreign Direct Investment firms located in Malta – particularly given the prevailing economic turmoil.

Fourth, employers may find it difficult to finance the cost of the new contribution which could result in a contraction in the labour force in the short term as employers may shed staff to reduce cost; and a reduction in labour demand in the medium and long term as employers adjust – structurally and otherwise – to a new employment cost.

The converse, and fifth, may also apply to an employee. A person who would have opted out of the labour force – for example a parent due to child rearing responsibilities – may decide not to return into the labour market as the increase in cost will result in a lower return which will not render it worth his or her while.

Sixth, there is a danger that black economy employment will increase – as both employer and employees will seek informal ways of employment in order to by-pass what will be perceived as a 'cost' – defeating the philosophy and purpose of why a mandatory Second Pillar Pension should be introduced in the first instance.

03.3 The 2008 Economic Collapse and Its Impact on Private Pensions

03.3.1 The Behaviour of the Private Pensions Market between 2001 and 2007

The objective of this section of the Chapter is to assess the impact of the economic and financial turmoil in 2008 and the subsequent impact on private pensions. To determine the impact of the 2008 economic collapse it is pertinent to understand the performance of private pensions in the years prior to the economic turmoil unleashed in 2008. This analysis is primarily based on studies carried out by the OECD.

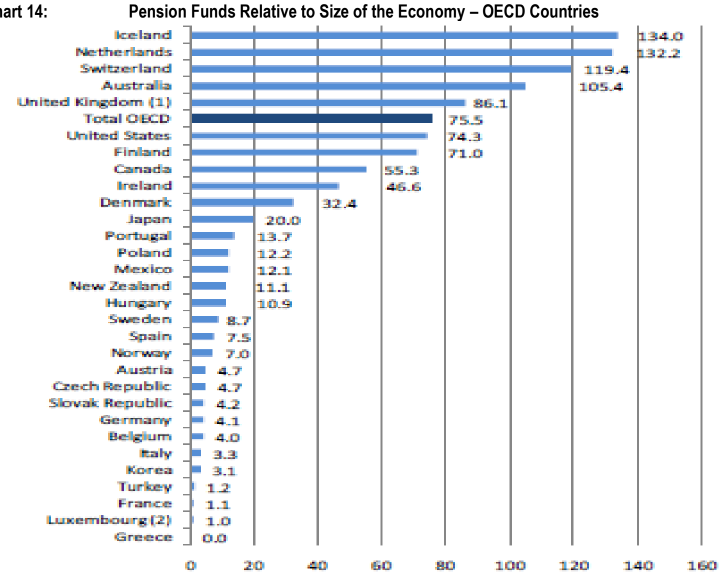
Over the past two decades there has been a market shift towards funding private sector management in pension systems – driven by the introduction of a mandatory private pension; public pension reserve funds to provide financial support to PAYG systems; and the increase of private pension instruments.

The OECD estimates that private pension assets in OECD countries increased by 14.5% relative to GDP, on average, between 2001 and 2007.

In 2007, approximately US$28 trillion assets were accumulated in private pension systems – of which 60% (US$17 million) were held by the United States (US) private pension system. In terms of the market value of assets accumulated relative to the size of the economy, Switzerland had the largest private pension system with a ratio of private pension plan assets to GDP of 152%. The OECD weighted average ratio of private pension assets to the area's GDP stood at 111% in 2007.[10]

As **Chart 14** below shows, in 2007 only four OECD countries achieved asset-to-GDP ratios higher than 100%: Iceland (134%); the Netherlands (132%); Switzerland (119%); and Australia (105%). In addition to these countries, the United Kingdom exceeded the OECD weighted average asset-to-GDP of 75.5%. It is pertinent to note that only eleven out of thirty countries had assets-to GDP ratios of above 20% - which is the minimum for meeting the OECD's definition of a 'mature' pension fund market.

Chart 14: **Pension Funds Relative to Size of the Economy – OECD Countries**



Source: OECD Global Pension Statistics

In most OECD countries bonds and equities are the two most important asset classes for pension funds – though the proportionality of equity and bonds varies considerably across countries. For example, in Belgium equities outweigh bonds by 48% to 21.5%; Canada by 50% to 34.4%; Germany by 31.3% to 28.8% and the US by 59.2% to 22.4%.

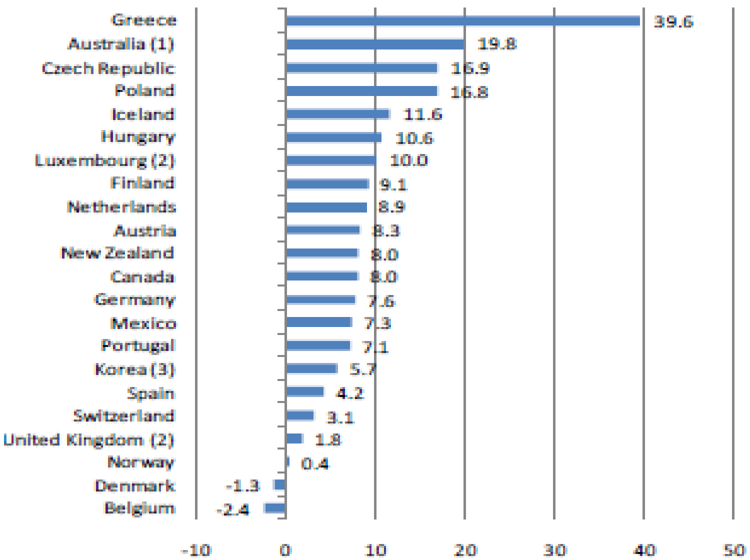
It is to be noted, however, that between 2001 and 2007, investment in equities by pension funds decreased by 2.1% whilst investment in bonds increased slightly by 0.3%. It is also pertinent to note that whilst institutional investors' total assets increased by 11% - pension funds increased by only 7% whilst those of insurance companies and investment funds increased by 11% - demonstrating a slight loss of importance of pension funds amongst 'traditional' classes of investors. Nevertheless a large share of the assets held by private equity is the property of pension funds.

[10] Pg 10, Issue 5, Pension Markets in Focus, OECD, December 2008

Financial assets held by investors are heavily pensions oriented – as much as 60% of the total volume of assets held by institutional investors world-wide has, as its main purpose, the financing of retirement benefits.[11]

In 2007, with the exception of Belgium and Denmark, all OECD countries' pension funds resulted in positive net income flows – primarily through to contributions and investment income such as interests and dividends as well as increases in asset values. Nevertheless, 2007 was perceived to be worse than 2006 – where in 2006 all countries demonstrated positive net income flows.

Chart 15: Pensions Funds Net Income - 2007



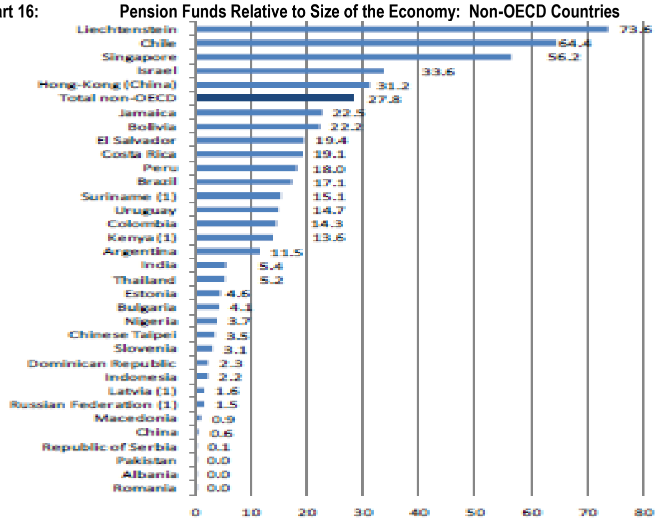
Source: OECD Global Pensions Statistics

The negative income flow experienced by Belgium and Denmark is thought to have resulted due to the sale of equity. Countries that experienced substantial increases in contribution were primarily countries that have embarked upon a pensions reform as part of their respective efforts to reduce the pension deficit.

Non-OECD pension fund markets, although small in comparison to the OECD area – (US$0.8 trillion vs US$17.9 trillion) have grown rapidly during the period reviewed. The Chilean pensions market, for example, grew from US$55.6 billion in 2004 to US$105.6 billion in 2007. Pension fund assets in Slovenia increased from US$0.5 billion in 2004 to US$1.4 billion in 2007.[12]

[11] Pg 13, Ibid
[12] Pg 15, Ibid

Chart 16: **Pension Funds Relative to Size of the Economy: Non-OECD Countries**



Source: OECD Global Pensions Statistics

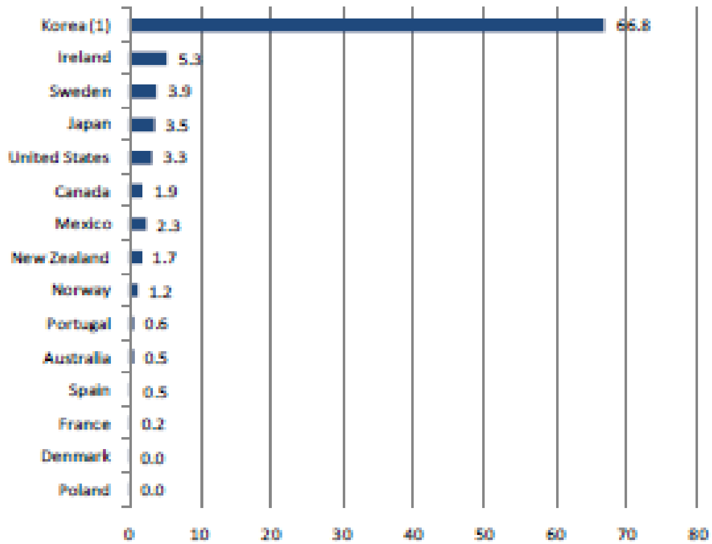
As shown in **Chart 16** above, only six countries meet the OECD definition of a 'mature' pensions system – that is, having an asset-to-GDP ratio of above 20%: Liechtenstein; Chile; Singapore; Israel; Jamaica; and Bolivia.

Moreover, between the period 2001 to 2007 public pensions reserve funds (PPRFs) increased steadily. The total amount of PPRF assets was equivalent to US$4.3 trillion compared to US$2.6 trillion in 2001 – with the average growth rate of global PPRFs for the said period being 8.4%. The average-to-GDP asset ratio stood at 13.1% in 2007, compared to 12.6% in 2001.

It is pertinent to note that PPRFs increased in their equity allocation over the said period – primarily spurred by the PPRFs search for high long term returns. Investment in bond allocations during the same period decreased. **Chart 17** below shows the pool of assets in PPRFs for select countries in comparison to the annual value of public pension benefits – where the larger the ratio the less is the need to embark upon fundamental reforms of the pension system to secure sustainability vis-à-vis aging costs.[13]

[13] Pg 16, Ibid

Chart 17: **Ratio of PPRF and Public Pension Expenditure**



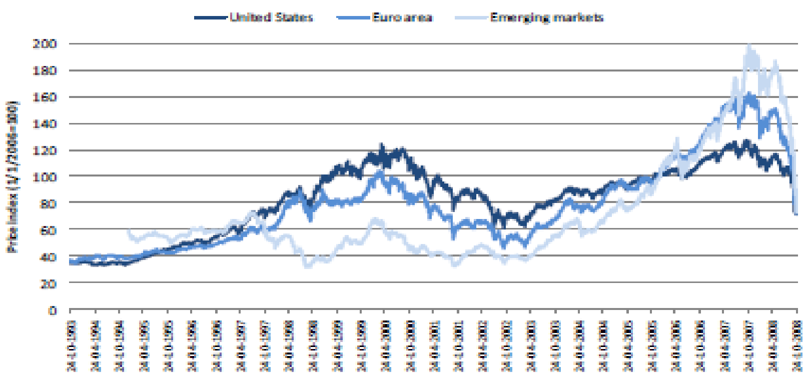
Source: OECD various national sources for PPRFs and OECD estimates on pension expenditure

Chart 17 above shows that the Korean PPRF assets could cover, in 2007, more than 66 times its annual expenditure on public pensions.

03.3.2 The Impact of the 2008 Economic Collapse on Private Pensions Market

As shown in **Chart 18** below, the stock market in October 2008 lost approximately 50% of its value when compared to the beginning of 2008.

Chart 18: **Stock Market Performance: Q3 1993 to Q3 2008**

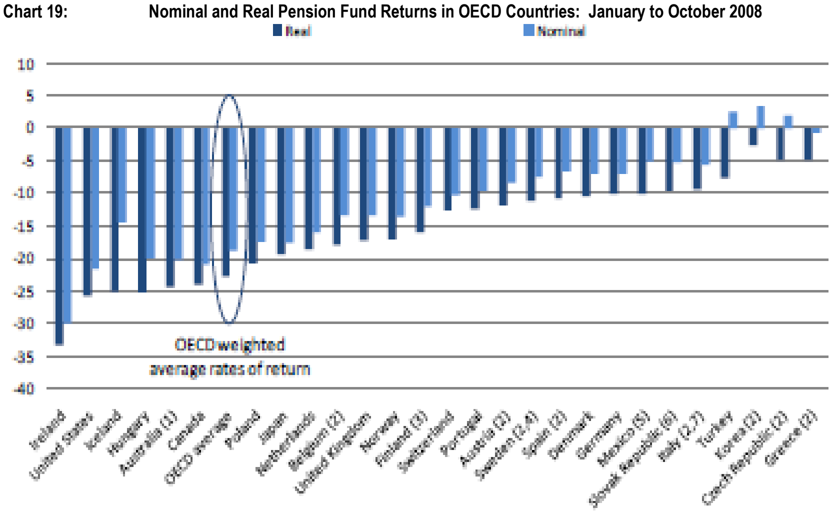


Source: Thomson Financial Datastream

The crash in the equity market had a major impact on private pension systems – given that, as shown in the previous section of this Chapter, private pension funds invested a considerable part of their assets in equity. By October 2008, the total assets of all pension funds of OECD countries experienced a *negative return* of approximately 20% (22% in real terms) - relative to 10 months earlier (December 2007). The principal loss in return is accounted for by pension funds in the US which experienced a loss of US$2.2 trillion out of the total OECD loss of US$3.3 trillion primarily because these pension funds account for more that 50% of the pension fund assets of all OECD countries.[14]

As shown in **Chart 19** below, only four other OECD countries saw pension fund returns worse than minus 20% in nominal terms.

Chart 19: **Nominal and Real Pension Fund Returns in OECD Countries: January to October 2008**



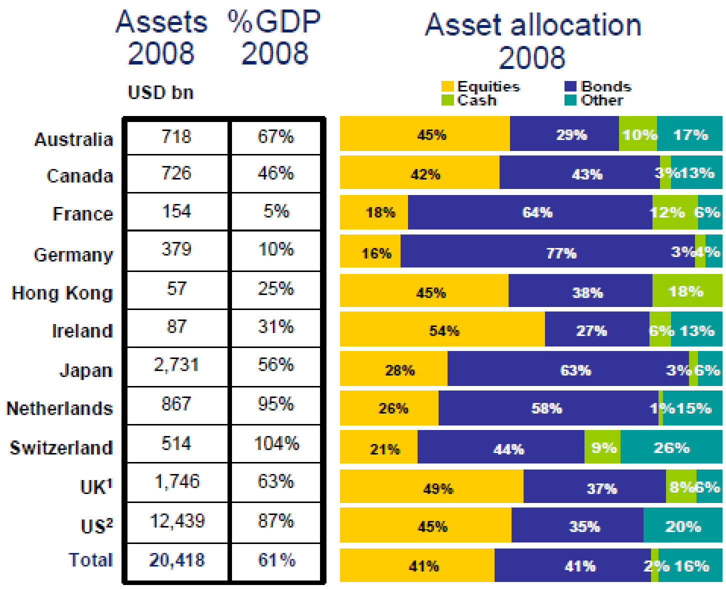
Source: OECD Estimates

In absolute terms, the second largest loss was the UK – US$0.3 trillion; followed by Australia US$0.2 trillion. *Investment losses* on all OECD private pension plans – including retirement accounts and pension insurance contracts – are estimated at US$5.5 trillion – of which US$3.3 trillion are in the US alone.

The OECD states that these losses, though substantial, are smaller than the decline in equity value primarily due to the fact that pension funds had diversified portfolios including substantial investment in bonds – estimated at 50% of assets, of which 60% were estimated to be invested in government bonds.[15] Watson Wyatt Worldwide estimate the assets as a % of GDP and in terms of portfolio allocation for some of the most advanced nations to be as shown in **Chart 20** below[16]:

[14] Pg 15, Private Pensions and the 2008 Turmoil in Financial Markets. OECD Private Pensions Outlook 2008, OECD, 2009
[15] Pg 4, Issue 5, Pension Markets in Focus, OECD, December 2008
[16] Pg 6, Global Pension Assets Study, Watson Wyatt Worldwide, January 2009

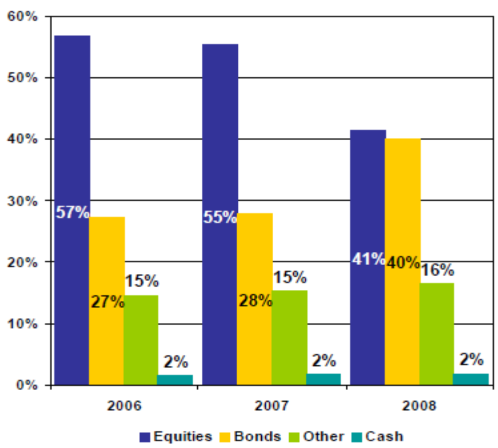
Chart 20: **Asset in 2008 as a % of GDP and Asset Allocation**



Notes: Excludes Personal and Stakeholder DC Assets
Excludes IRAs
Source: Watson Wyatt Worldwide

The behaviour of the asset allocation portfolio for 2008, as shown in **Chart 20** above, when compared to 2007 and 2006 is shown in **Chart 21** below:

Chart 21: **Asset Allocation Portfolio Behaviour – 2006 to 2008**



Source: Watson Wyatt Worldwide

As can be seen from the above chart that the share of equities, for reason discussed above, has fallen considerably. On the other hand the share of the investment in bonds allocation has increased – to a large part in proportion to a substantial decrease in the value of the equity portfolio as well as the channelling of investment into bonds which provide greater stability.

The impact of the crisis on investment returns has, therefore, been greatest amongst pension funds in countries where equities represented over a third of the total investments in equity. Ireland, was the worst hit at -30% in nominal terms given that Irish pension funds were the most exposed to equities, at 66% of total assets on average – followed by the US, UK and Australia.[17]

As can be seen in **Table 06** the annual growth rates are significantly negative when comparing 2008 rates to those of 2007 – clearly demonstrating the effect of the world financial crisis. The table shows that whilst in 2007 several countries were still growing, in 2008 all experienced losses with the exception of Germany.

Table 06: Global Pension Assets Growth Rate

Market	1-year (31/12/06-31/12/07) Actual	Growth rates to 2008e (USD)		
		1-year (31/12/07-31/12/08)	5-year (31/12/03-31/12/08) CAGR	10-year (31/12/98-31/12/08) CAGR
Australia	34.3%	-33.9%	11.1%	13.4%
Canada	17.6%	-29.4%	0.0%	5.5%
France	7.9%	-9.9%	2.1%	7.1%
Germany	17.9%	-3.2%	10.6%	8.2%
Hong Kong	20.2%	-24.6%	9.1%	10.4%
Ireland	10.1%	-31.6%	6.6%	6.6%
Japan	-1.1%	-1.5%	-1.2%	1.8%
Netherlands	7.4%	-18.1%	7.2%	6.3%
Switzerland	12.6%	-4.6%	7.7%	3.9%
UK[1]	10.1%	-35.0%	6.7%	4.2%
US[2]	10.5%	-18.9%	4.6%	3.3%
Total (USD)	10.2%	-19.2%	4.1%	3.7%

Notes: Excludes Personal and Stakeholder DC Assets
Excludes IRAs
Source: Watson Wyatt Worldwide

The above table also shows that the global pension assets measured in local currency fell by 14.7% when compared to the 5 year compound average growth rate (CAGR) of 4.8% and the similar 10 year CAGR of 5.0%.[18] Watson Wyatt Worldwide conclude that there also was a significant decline in the ratio of pension assets to GDP during 2008: which fell from 82% recorded in 2007 to 61% in 2008. In essence, this shows that the global pension assets to GDP ratio practically regressed to 1996 levels – when this ratio stood at approximately 57%.

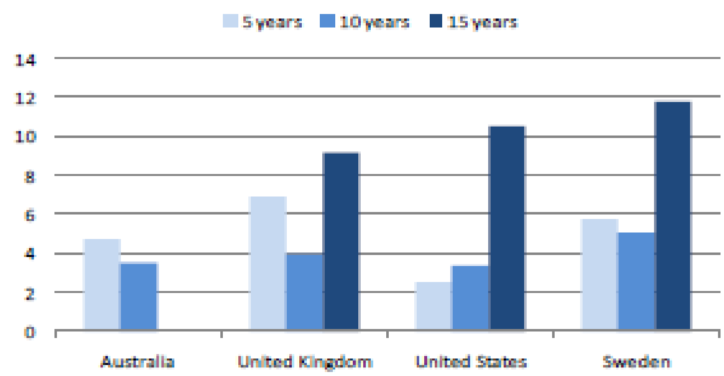
It is pertinent to underline that the decline in equity experienced over 2000-2002 was just as serious as that experienced in 2008: with the latter, however, taking place at a far more acute rate. The OECD concludes that despite the severity, as well as proximity, of these two market downturns, pension funds

[17] Pg 15, Private Pensions and the 2008 Turmoil in Financial Markets. OECD Private Pensions Outlook 2008, OECD, 2009
[18] 2009 Global Pension Assets Study, Watson Wyatt Worldwide, January 2009

had a positive performance over the past ten years and a healthy one over the last fifteen years – with the exception of October 2008.

As **Chart 22** below shows, the average annual nominal rate of return of pension funds over the last fifteen years was 11.8% in Sweden (8.5% in real terms); 10.6% in the US (6.1% in real terms); and 9.2% in the UK (6.1% in real terms).[19]

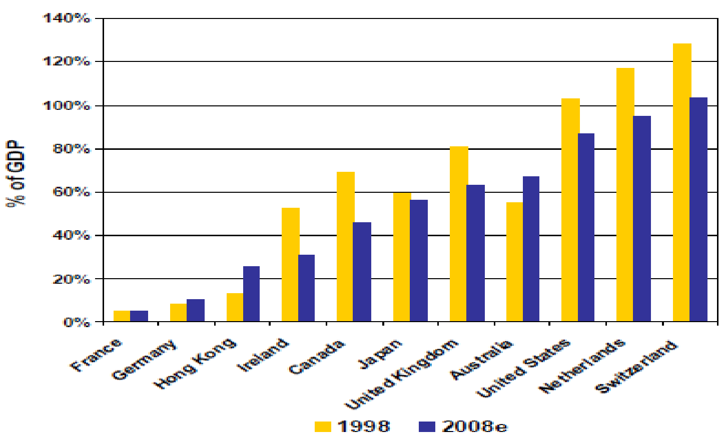
Chart 22: **Nominal Average and Annual Pension Fund Returns in Selected OECD Countries over last 5, 10 and 15 Years**



Source: OECD Estimates

As can be seen in **Chart 23** hereunder, Switzerland, Canada, the Netherlands and Ireland experienced major declines in pension assets to GDP ratio. On the other hand, pension assets to GDP have recorded significant increases in Hong Kong and Australia over the ten year period to 2008.

Chart 23: **Global Pension Assets vs GDP**

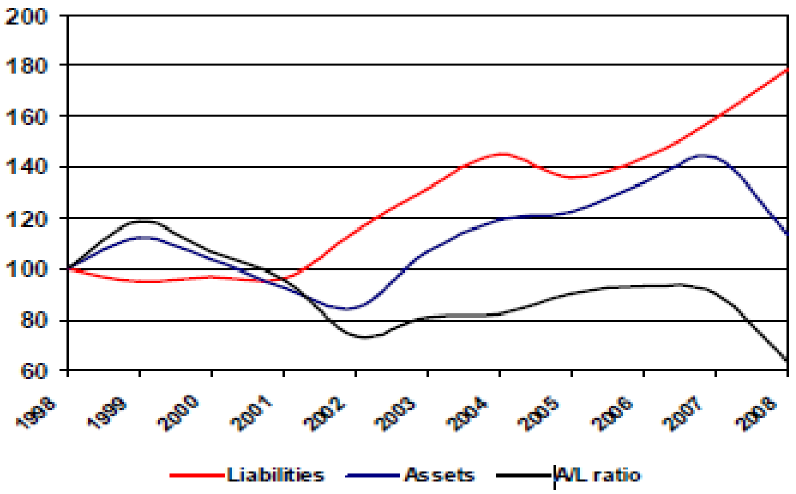


Source: Watson Wyatt Worldwide

[19] Pg5, Issue 5, Pension Markets in Focus, OECD, December 2008

With particular regard to Defined Benefit pension schemes, Watson Wyatt Worldwide clearly shows that the asset – liability indicator has deteriorated as can be seen in **Chart 24** below which portrays the Asset : Liability Ratio for the period 1998 to 2008:

Chart 24: **Asset : Liability Ratio of Defined Benefits Schemes**



Source: Watson Wyatt Worldwide

The above Chart implies that Defined Benefits pension fund balance sheets saw their assets shrink amid the financial crisis and liabilities surge during the same period. As can be seen from **Table 07** below this is a trend that Defined Benefit schemes have been experiencing for most of the past ten years – with the sharp decrease in 2008 exceeding only 2002 in terms of the acuteness of the deterioration process in the value of the fund.

Table 07: **Changes in Assets and Liabilities of Defined Benefits Schemes**

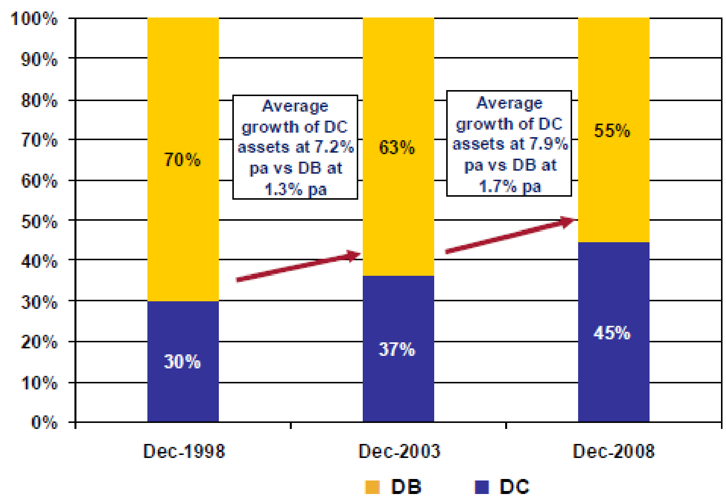
Year end	Liability increases relative to end 1998	Asset increases relative to end 1998	Asset liability indicator - cumulative change relative to end 1998	Asset liability indicator - change in year
1999	-5.1%	12.5%	18.5%	18.5%
2000	-2.9%	3.9%	6.9%	-9.7%
2001	-3.6%	-7.4%	-4.0%	-10.2%
2002	15.0%	-15.2%	-26.3%	-23.2%
2003	31.7%	6.7%	-19.0%	9.9%
2004	45.0%	19.0%	-18.0%	1.3%
2005	35.6%	22.5%	-9.6%	10.2%
2006	43.6%	33.7%	-6.9%	3.0%
2007	59.1%	43.7%	-9.7%	-3.0%
2008	78.2%	13.6%	-36.3%	-29.4%

Source: Watson Wyatt Worldwide

The deterioration in the liabilities of Defined Benefit schemes and their subsequent negative impact on the balance sheets of governments and firms providing such a form of pensions scheme is not surprising. A review of literature relating to Defined Benefits Schemes over the past years have been dominated by increasing concerns that Operational Pension Retirement (OPR) Defined Benefit schemes liabilities' are having on the viability and sustainability of major corporations such as, for example, British Airways.

As can been seen in **Chart 25** below, a process of migration from Defined Benefit schemes to Defined Contribution was already experienced between 1998 and 2003; with a trend which has continued between 2003 and 2008 – a migration resulting from the balance sheet pressures that Defined Benefit OPR schemes are placing on the sustainability of institutions and companies providing such schemes.

Chart 25: Defined Benefit Schemes and Defined Contribution Schemes Assets



Source: Watson Wyatt Worldwide

03.3.3 The Impact of, and Reactions to, the 2008 Economic Crisis on Retirement Pensions

In a Defined Contributions pension scheme (DC) the value of the pension depends directly on the market value of the assets held in individual accounts. Thus the significant drop of the value of equities in pension funds as discussed earlier in this Chapter will have a direct impact on the value of a pension **at the point** the person retires and starts to draw down his or her private market pension.

In essence, therefore this has a number of significant impacts. Given the fall in the value of pensions funds in 2008 persons who retire in 2009 will, undoubtedly, be negatively affected in terms of the value the pension they will receive. Markets perform, however, cyclically. Thus, a person who entered the labour market in 2009 or is a relative young worker who has been in the employment market for a number of years will most likely not be negatively impacted by the 2008 crash as the market would have recovered from this particular crash – and potentially gone through a number of cyclical different economic performances.

A person, however, who is elderly and close to retire and who would have to purchase annuities at the time of when he retires, in say two years time or so, would most likely suffer a permanent income loss in the money saved in the pensions account.

A Defined Benefits pension scheme (DB) on the other hand is, in principle, unaffected by changes in investment returns. Nevertheless, as discussed earlier in this Chapter, lower asset prices will have a negative impact on a country or corporation that base their national or OPRs pension funds on a DB scheme. As demonstrated earlier, countries such as Canada, Ireland, Switzerland and the Netherlands which have large defined schemes are reporting lower funding levels and in some cases large pension liabilities.

In this regard, it is pertinent to quote at length the OECD which states that:

> "It can be difficult to know the real situation of funds because of the accounting practices used by the pensions industry. The price of pension liabilities in company balance sheets is calculated using corporate bond yields which have a risk premium above government bonds. The calculation is based on the on high quality corporate bonds where the normally there is little risk. However, if these bonds are seen as more risky, as happened in 2008 when even large, well established firms got into trouble, the risk premiums increases. In some instances – e.g. the UK – this effect has largely countered in asset values, on paper at least. However, if one looks at the funding levels reported by supervisory authorities – which are often based on more stable government bond yields – declines in solvency are substantial."[20]

In Switzerland and the US, the funding position of DB pension schemes has deteriorated by more than 10% - with rising bond yields partly offsetting the decline in asset values. Pension funds in the Netherlands have also experienced sharp falls in asset values, primarily their equity portfolio exposure in the US market. The OECD states that as the market discount rates applied – which are based on swap rates – declined, the rise in the market value of liabilities worsened; with aggregate funding levels having fallen by 10% between December 2007 and June 2008 before the worst of the financial storm had even hit the financial markets.[21]

Moreover, the funding gaps between DB OPR pension schemes funds and the employers' balance sheet is forcing employers to embark upon recovery plans to reduce the deficit. Solutions tend to range from an employer increasing the level of contributions or in reducing the actual benefits that are supposed to be guaranteed under the DB OPR scheme.

In the Netherlands, for example, where conditional indexation of benefits is widespread, pension funds are being seen to react to lower funding levels by stopping the indexation of benefits to wage inflation until funding levels increase. In real terms a pensioner's real income will fall and the real value of accrued benefits will fall in an equal manner. The intention is that, once funding recovers to a sufficiently high level, pension funds will compensate for the lost indexation with higher benefits.

Employees in DB OPR schemes could experience benefit loss if they lose their job before they complete the vesting period, or if deferred benefits are not protected against inflation. An employee who is a member of a DB OPR scheme may lose his or her pension, or a substantial part of it even if legislation provides protection, in the event that the employer goes bankrupt and the pension scheme is underfunded.

The reactions to the impact of the current cyclical economic turmoil are seen to include the following:

01. One consequence of the economic crisis is that there will be a backlash against private pension systems: such as shrinking the private pension market by nationalising pension funds and bringing these back into the public pension system. This happened in Argentina, which brought in participants in private pension back into the public pension system. Similar discussion is underway in a number of Eastern European countries.

02. Another consequence of the economic turmoil is that decisions to reform a public pension system by introducing a mandatory Second Pillar Pension component will be deferred for a period of time or, potentially, indefinitely due to the savaging experienced by private pensions.

[20] Pg 6, Issue 5, Pension Markets in Focus, OECD, December 2008
[21] Ibid

03. The decision to defer or scrap a plan to introduce a Second Pillar Pension is also dependent on the timing of the introduction of a mandatory Second Pillar Pension. In an age where globalised events are projected to people within minutes of their taking place it will be difficult, if not impossible, to persuade – let alone enforce people to invest in a mandatory private Second Pillar Pensions.

The real and political difficulties that would have to be overcome will be significant – and could easily transform themselves into social unrest particularly if the private pensions market continues to be billowed by the economic and financial turmoil. Thus, the timing of when a Second Pillar Pension is introduced will be of critical importance – requiring deferment until such time when the financial markets generally and private pension markets specifically start to rebound and long term confidence starts to re-build once again.

04. Where private pensions schemes exist – whether of a mandatory or voluntary nature or whether these are DC or DB schemes – a flight from equities will be experienced in the short-term, and potentially lead to a psyche which will prevent private pension schemes to invest in equity over the long term.[22]

Whilst such positioning of asset portfolios will render private pension schemes safer and more stable; the fact is that the level of the value of a pension when an annuity is purchased would be far lower than if such a portfolio held equity – albeit in a 'normal' market scenario.

Alternatively schemes will be re-designed to introduce 'triggers' that will allow for induced temporary changes in the calculation of pension fund liabilities and solvency margins in order to reduce pressures on pension funds to sell equities as has happened in Finland.

03.4 Conclusions

From the above economic impact assessment the WG concluded that, within the current cyclical period of an economic recession as well as significantly lower level of confidence in the market, the introduction of a mandatory Second Pillar Pension will:

01. Most likely increase aggregate savings as well as individual savings; ensuring therefore a smoother transition from a quality of life enjoyed during a person's employment to a lower retirement pension income that is subject to the First Pillar Pension replacement rate.

02. Negatively impact disposable income particularly with regards to low income and lower middle income groups.

03. May potentially result in increased debt by an individual – particularly those in lower income groups – in order to compensate for a lower level of disposable income due to the payment of the mandatory Second Pillar Pension contribution.

04. May potentially have a neutral or minimal impact on individuals in high or middle income groups who already save in endowment or unit-linked policies in the event that they would opt to lock the surrender value or maturity value of such schemes in a Second Pillar Pension – although this would mean that a lower level of aggregate savings would be achieved if this measure had to be implemented.

05. Have a negative impact on government finances as contributions paid by the State as an employer will be ring fenced in a Second Pillar Pension Fund; with the payment of the additional

[22] Pg 4, Issue 5, Pension Markets in Focus, OECD, December 2008

contribution to be hived off from government revenue or raised through taxation, debt or a reduction in its productive investment programme.

06. Result in the loss of 1% of annual National Insurance Contributions as the portion carved out of the First Pillar would be lost to the Second Pillar – in the event that this constitutes an option for consideration by Government.

07. Result in a high level of deferred taxation and revenue foregone by Government in the event that Government embarks upon a tax incentives or subsidies framework to propel an aggressive take-up in a Voluntary Second Pension and Third Pension.

Commented [PBC1]: We are talking about the effects of the introduction of a MANDATORY second pillar so I think this point is out of place. Government would not need to induce takeup because it is mandatory.

08. Result in a reduction of revenue due to VAT income which is deferred as income is saved for retirement.

09. Result in the passing on of the cost of the mandatory Second Pillar Pension contribution by the employer to the consumer.

10. Result in the demand by employees for increase in salaries and Cost of Living Adjustments to compensate in part or in full for the negative impact on net earnings due to the mandatory Second Pillar Pension contribution.

11. May result in industrial unrest as employers and Unions, as well as Government, fail to find a balanced common ground as a result of the introduction of the mandatory Second Pillar Pension.

12. Result, in the short term, in the contraction of the demand for labour as employers rationalise employment costs to absorb their part of the contribution to the mandatory Second Pillar Pension; and a potential reduction in the labour demand over the medium and long term as employers structurally adjust to the mandatory Second Pillar Pension.

13. Result in the loss of employment in relation to overseas markets, tourism, and FDI investment as price competitiveness is eroded.

14. May result in an increase in black economy employment as both employers and employees will seek to by-pass the 'new cost' – the contribution to the mandatory Second Pillar Pension; and in doing so undermining the raison d'être for a mandatory Second Pillar Pension in the first place.

15. May discourage persons who are outside of the employment market to re-enter the labour market because the return for doing so would not render it worthwhile in the present and immediate term.

16. Given that citizens' confidence in the private market is, to a certain degree, negatively affected by the turmoil in international financial markets, an imposition to force consumers to mandatorily save in a private pensions framework may result in a backlash of public opinion and public reaction against such a policy decision.

The WG is of the considered opinion that, for a mandatory Second Pillar Pension to be smoothly introduced and implemented, a stable financial and economic outlook in both the immediate and medium term is of fundamental importance.

Moreover, the introduction of a mandatory Second Pillar Pension in an ambiance of consumer loss of confidence in private market instruments militates against a consideration of the introduction of a mandatory Second Pension in the immediate term.

In this regard, the WG argues that the recommendation proposed by the PWG in its Final Report that a mandatory Second Pillar Pension is introduced by not later than 2010 under the prevailing economic and financial conditions no longer holds. Yet it is pertinent to underline in the strongest terms possible that

Malta still faces structural issues with regards to the sustainability of pensions. This is clearly demonstrated in Chapter 01.

The consideration of a deferment in the introduction of a mandatory Second Pillar Pension – or for that matter further structural reforms to the First Pillar Pension – stems only because current cyclical economic and financial behaviour leads one to conclude that an increased burden onto persons and employers under such conditions will, must likely, result in a further worsening of the current economic and financial state of play in Malta.

The fact, therefore, remains that further structural reform in the pensions' framework is a necessity that cannot be avoided. At best it can be deferred so that the introduction of such structural reforms is carried out at the time when the prevailing financial and economic conditions will enable a smooth absorption of the arising impacts,

In this regard, the WG strongly argues that the deferment of the structural reforms required in the pensions framework are only deferred until such time that the economic conditions – which include GPD growth, labour growth, labour productivity, et al – are in place.

Recommendation 03
The Working Group underlines that, whilst the importance of addressing the structural issues of the pensions framework is a matter of pressing national concern, further structural reform should be deferred until such time that the appropriate economic conditions – GPD growth, labour productivity, labour growth, etc – are reached so that the prevailing financial and economic conditions will enable a smooth absorption of the arising impacts.

It is, thus, further proposed that the Government should secure consensus with the civil society partners – particularly the representatives of employers and employees respectively – on what constitutes the appropriate conditions for further structural reform in the pensions framework so that once these are reached the process of further reform is immediately embarked upon.

Recommendation 04
The Working Group recommends that Government and Civil Society partners achieve consensus on what constitutes appropriate economic conditions under which further reform of the pensions framework is embarked upon; so that once such conditions are reached reform can be embarked upon immediately and as smoothly as possible.

04.1 What Role for Private Second and Third Pillar Pensions In Maintaining a Balanced Framework for Retirement Income?

As shown in the previous Chapter, the financial turmoil and the ensuing economic crisis have had a major negative impact on private pension assets. The economic and financial crisis has reduced the value of assets accumulated to finance retirement by, at least, 20% to 25%. As further discussed, the crisis is also causing a shift in the asset allocation patterns: with investors moving into more conservative investments – a trend which has been noted by pension regulators in OECD countries such as Norway, Slovakia, Spain and Turkey.

The funding levels of pension funds providing DB pensions have fallen well below 90% in most OECD countries – a result of which is the value of their assets fails to cover their pension liabilities. The Dutch regulator, for example, and the Dutch Association of Industry-Wide Pensions Fund report that the coverage ratio in most pension funds in the Netherlands have dropped below 95% versus their minimum requirement of 105%.[23]

A direct consequence is that some governments are being pressured to retreat from private pension provisions. For example, Argentina has, de facto, nationalised private pensions, and there is policy discussion about reverting back towards PAYG public pensions in some Central and Eastern European countries (allowing individuals to reverse their previous decisions to opt out of the public system and join the new, individual account arrangement).

Yet – will a reversal in the design of well balanced public-private pension provision to a more public financed pension provision address the issues of sustainability of public pensions whilst securing adequacy?

The rationale supporting a well balanced public-private pension framework is that of diverting risk – where:

- the public aspect of the pension framework is primarily dependent on the demographic risk and the resulting demographic replacement rate – that is, how many persons will be in employment to support every pensioner.

- the private aspect of the pension framework is dependent on the market exposure of the pension instrument on the one hand, but separated from under-funding of public pensions or in the case of Malta, where no such public pension fund exists, on the solvency of the Consolidated Fund.

The initial analysis carried out in this report, that of incorporating the new macro-economic based assumptions as stipulated by the AWG of ECOFIN, shows that by 2050 the replacement rate of a pension in comparison to an average salary will be 41.5%.

In line with the above, it is pertinent to emphasise that, for this replacement rate to be sustained, the pension deficit to GDP will increase from the current (2.5%) – where the replacement rate today stands at approximately 50% - to (7.2%) of GDP by 2050.

It so follows that, in a political and social ambience where the social benefits structure provides for free education, free health, a wide and pervasive social net, coupled by the fact that Malta is now a mature

[23] Pg 4, Antolin, P., and Stewart, F., Private Pensions and Policy Responses to the Financial and Economic Crisis, OECD Working Papers on Insurance and Private Pensions No 36, OECD Publishing, 2009

economy and hence will experience lower growth rates, there will, undoubtedly be sustained pressures for Malta to maintain a pensions GDP deficit of (7.2%). Hence, on the basis of these results, the WG concludes that there will surely be issues of long-term sustainability of public finances associated with the current First Pillar Pensions framework.

In the event that future governments are to take measures to reduce the pensions GDP deficit to more acceptable levels (it is pertinent to note that a (2.5%) deficit is reflective of the state of play today) this would mean that the projected average pensions replacement rate of 41.5% will fall – and potentially fall steeply.

In essence this implies that structural reform, as emphasised in the previous Chapter, is not a matter of 'if' but 'when'.

The importance of this structural reform stems not only from the need to ensure a sustainable pensions framework but, as importantly, to ensure adequacy of pension income at the time it is received. Data on saving patterns shows that Maltese persons are changing their savings patterns. Mortgage investment in home ownership (which constitutes over 75% of households and a mortgage should be categorised as a kind of 'long term investment' rather than a 'consumption related expenditure') is the new form of 'savings' for many households. Yet, investment in home ownership does not necessarily translate into accessibility to liquid finance. The WG, therefore, cannot but conclude that Maltese persons will experience a potentially widening gap between the income they enjoyed and the pension they are receiving: a gap that will have a significant negative impact on a person's quality of life in retirement.

The question that arises is: what form should continued structural reform of the pensions framework take? Should emphasis be directed toward continued strengthened of the PAYG – First Pension Pillar – where-in the risk stemming from the lower demographic rate remains – with Government (and the tax payer collectively) assuming the liability at the time the risk becomes a reality.

Or should the continued structural reform of the pensions' framework be on the basis of balancing risk between demographics on the one hand and market behaviour on the other – as originally proposed by the PWG?

The WG concurs with the current school of thought that the international financial market will rebound. The key question being: when will this take place and to what extent will the global and national financial stimuli measures work in accelerating such a rebound. The world has experienced many a financial crisis – in 1981, 1987, 1992, 1997, 2002 – in the last three decades alone, and each time the market rebounded stronger as it grafted onto itself lessons learnt from each crisis.

The WG, however, is strongly of the considered opinion that the structural deficiencies in the public pension provision are more likely to degenerate rather than improve over time:

- Malta is an aging population;
- the pension replacement ratio is dependent on the number of persons in the workforce, a number which is decreasing;
- there is no public pension fund ring fenced from the Consolidated Fund.

Thus, the WG is of the considered opinion that the financial and economic crisis, ***of itself***, does not diminish the importance of private pension provision in a well balanced private public pension framework directed to ensure a quality of life during retirement.

In this regard it is believed to be pertinent to refer to the private pensions policy response to the economic and financial crisis issued by the OECD[24] in June 2009. The policy response of the OECD states:

[24] Pg 7, Private Pensions and Policy Responses to the Crisis – Recommendation on Core Principles of Occupational Pension Regulation, OECD, June 2009

> "Assessing policy responses to the financial and economic crisis in light of OECD and IOPS guidelines and best practices, has helped in drawing some lessons on the important role of private pensions in complementing public systems, and on how pension arrangements should be best designed to introduce some degree of protection, improve sustainability of funding, enhance management and supervision, and set up disclosure and communication. The main messages of this assessment are as follows:
>
> - Stay the course. Complementary private provision for retirement remains a necessity. Whilst some governments are being pressurised to retreat from private pension, public PAYG systems face sustainability problems given aging populations and also affected by the crisis as unemployment increases.
>
> Private pensions still have a major role to play to maintain balanced sources of retirement income. …"

Furthermore, the initial projections, using the AWG assumptions, highlight a greater scope for the provision of a Second Pillar Pension given the expected trajectory of replacement rates and pension deficit to GDP ratios over the forthcoming years. In line with Recommendation 01 of this document the forthcoming Structured Review of Pension reform will deal with the necessary fine tuning adjustments which need to be implemented to the pension system as a result of the new AWG assumptions.

As discussed earlier the introduction of a mandatory Second Pillar Pension under the existing economic financial and psychological conditions is not appropriate. Structural reform in this regard is a matter of time.

The WG, nevertheless, is strongly of the considered opinion that a policy of 'no action' until such time as appropriate economic conditions prevail to allow for the mandatory introduction of a Second Pension Pillar is not a sound policy option.

The current state of play is such that even if a person, or an employer, on his or her own regard seeks to invest in private pension funds over and above the PAYG national pension or introduce an Occupational Pension Retirement Scheme such an action is not possible.

The "pension and retirement" schemes that are sold locally are <u>not</u> pension funds: they are a financial services product that complements the array of such products sold locally. Until the appropriate legislative framework is enacted the introduction of Occupational Pension Retirement Scheme will not occur.

Recommendation 05

The Working Group concludes that the financial and economic crisis, *of itself*, does not diminish the importance of private pension provision in a well balanced private public pension framework directed to ensure quality of life during retirement, whilst the expected trajectory of replacement rates and the pension deficit to GDP ratio based on Aging Working Group assumptions provide a greater scope for the introduction of a Second Pillar Pension.

The WG is strongly of the opinion that during the interim period between the current economic situation and until such time where appropriate economic conditions will allow for the continued structured reform of the pension framework, that Government introduces a "soft" Second Pillar Pension based on a voluntary framework that will provide a person (or an employer) with the option and choice to invest over and above the First Pillar Pension.

Recommendation 06

The Working Group strongly recommends that until such time that the economy recovers from the current global recession the Government is to introduce the appropriate environment for a Voluntary Second Pillar (VSP) Pension framework and a Third Pillar Pension to provide persons with the option and choice to invest for their retirement over and above the First Pillar Pension.

The recent crisis and the related scandals nevertheless have severely tested confidence in financial institutions in general. Whilst pension funds are neither the source of nor a mechanism propagating the crisis, the introduction of a new VSP framework is unlikely to escape the general decline in confidence in financial services – particularly given that internationally there is "some evidence of a decline in contributions to voluntary schemes."[25]

This highlights the importance of the need to ensure that the launch of the proposed VSP is done in conjunction with a sustained confidence building exercise supported by the need to reduce and better communicate the risks and the exposure to 'worst case' scenarios for persons who will invest in the VSP framework.

The WG is of the considered opinion that the Government, the Malta Financial Services Authority and consumer protection government and non government organisations have a strategic role to play in this regard. It is pertinent to underline that the International Organisation of Pension Supervisors (IOPS) Principles highlight the need for the pensions regulatory authority to "provide and publish clear and accurate information for the pension industry and the general public on a regular basis – such as the financial situation of the pension fund industry and observations on major developments in the pension sector".

The WG adds that the role that the pensions regulatory authority should work with government and non government consumer protection organisations to propagate information on how schemes introduced in the market work and the return arising from each particular instrument.

Thus, the WG recommends that the adoption of the recommendations presented in this report with regards to the introduction of a VSP framework should be supported by a strong and sustained confidence building strategy together with the appropriate capacity building within the MFSA to ensure a sustained guidance and communications campaign.

Recommendation 07

The Working Group recommends that the adoption of the recommendations presented in this report with regards to the introduction of a Voluntary Second Pillar Pension framework should be supported by a strong and sustained confidence building strategy together with the appropriate capacity building by Government, the Malta Financial Services Authority and government as well as non government consumer protection organisations to secure a sustained information and knowledge campaign with regards to private pension instruments introduced in the market.

04.2 Providing a Foundation for Private Saving for Retirement

04.2.1 Catching People at the Beginning of their Employment Life before Spending Habits Become Established

The most suitable time for a person to start saving for his pension is potentially at the beginning of his employment life or when a person changes employment for a higher income before spending patterns become established.

[25] Pg 15, Antolin, P., and Stewart, F., Private Pensions Policy and Responses to the Financial and Economic Crisis, OECD Working Papers in Insurance and Private Pensions, No 36, OECD publishing, April 2009

It is argued that the reason why persons within cohorts who do not have a private pension – or in Malta a unit or profit based policy – is not because a person would have made a clear decision against such a provision. Rather, this is thought to be the result of the fact that a person would not have got round to taking the action, or is discouraged from seeking and going to financial specialists.

A 'soft' Voluntary Second Pension (VSP) is based on the rationale that a person who is in employment is automatically enrolled but that the said person would have the right to opt out and cease to be part of the scheme if he or she so wishes. It is pertinent to note that both the UK and New Zealand have contemplated the introduction of such a scheme.

A study carried out by the Department of Works and Pensions in the UK[26] on the automatic opt-in – opt-out pensions savings scheme shows that respondents stated the following reasons of why they decided to remain in the personal accounts scheme once automatically enrolled:

- 49% stated that they need to start saving for retirement.
- 31% stated that the scheme seemed like an easy way to save
- 31% stated that they wanted the employer to contribute to their pension.

The same survey showed that 22% would seek to opt out of such a scheme. The reasons stated for seeking to opt-out were:

- 27% stated that they would rather save in a different way other than in a pension.
- 16% stated that they already have a personal pension plan.
- 16% stated that they are too old to start saving.
- 16% stated that they could not afford to save.
- 12% stated that they were concerned about the return on investments and potentially losing their money.

The WG recommends that the Government considers the development and introduction of a VSP no later than 1st January 2011. The VSP, it is suggested, should be based on the following criteria:

- the automatic enrolment scheme will be directed at full-time employees who fall in the 'Switchers' category – that is employees who were 45 years and younger at the time the retirement age was increased to 65 years.
- an employee will have six weeks to decide whether to 'opt-out' and once the decision is taken he will inform the employer and the contribution paid for that period is returned to the employee.
- the contribution accrued during the 'opt-in / opt-out' period is placed with the employer in a special ring fenced account to which the employer will have no access to other then for administration purposes.
- the rate of contribution upon automatic roll-out will be set at 2% of gross salary and the employee will be provided with the choice to contribute more should he or she decide to do so .

[26] Pg 40, Saving for Retirement: Implications of Pensions Reforms on Financial Incentives to Save for Retirement, Research Report No 558, Department for Works and Pensions, Her Majesty's Stationery Office, United Kingdom, 2009

- the employee's contribution will be locked-in and he or she will be allowed to access his or her funds only upon retirement – that is at 65 years of age.

- that in the event of the death of the employee, the fund is inherited by next of kin.

- the person will be allowed to select his or her private pension instrument from any such pension instrument as may be regulated by the Malta Financial Services Authority.

- the employer will provide an employee with appropriate documentation prepared by MFSA, pension scheme providers, information on the choice of private pension instruments following the expiry of the 'opt-out' period.

- the employer will be responsible for the administration of the paper work and processing relating to entry into a private pension scheme (as defined in Section 1.04 in this document). It is acknowledged that whilst the proposed VSP scheme does not seek to place a contribution burden on the employer, the administration of the VSP scheme will have an administrative burden on the employer. This administrative burden will consist of the processing of the VSP scheme – forms, return of contributions on opt out, dissemination of information, etc. It is expected that the administration of such scheme would be absorbed by the Human Resources or Personnel departments in firms that have such a function.

- the employer is not mandated to pay any contribution to any employee that enrols in such a saving scheme. (One may consider introducing an incentive for employers who top up employee contributions)

Recommendation 08

The Working Group recommends that a 'soft' private pension framework that:

- provides for automatically enrolment within a Voluntary Second Pillar Pension for an employee who were 45 years and younger at the time the retirement age was increased to 65 years;

- provides him or her with the opportunity to opt out from the Voluntary Second Pension;

- is designed on the basis of the principles proposed in this Report with a target that such a Voluntary Second Pension is launched by 1st September 2010. (to update).

Although the proposed automatic opt-in/opt-out scheme is directed towards persons who were 45 years or younger at the time when the retirement age was increased (the 18 year period until retirement providing a reasonable period of time for a return on investment upon the maturity of the scheme) opt-in to persons who were in the 'transitional group' (46 years to 54 years when the retirement age was increased to 45 years) should be given the option to participate should they wish to do so.

Recommendation 09

The Working Group recommends that persons who were in the 'transitional group' (46 years to 54 years when the retirement age was increased to 45 years) should be given the option to participate in the Voluntary Second Pension should they wish to do so.

04.2.2 Establishing Pension Savings at Birth

The Social Security Act, Article 76A states that it is "the right of every child to have an allowance paid out in his respect to the head of household…".

The Children's Allowance (CA) benefit provided in terms of such a child's 'right' is subject to a means test on income, for children under the age of 16 years. Following the reforms to the CA benefit scheme dated 5th January 2008 all children of an eligible beneficiary are provided with an allowance that is 6% for each child.

The CA system is two tiered. In the case of a family whose declared income for the previous year is greater than €23,923, the fixed CA per child per annum is €250. In the case of a family where the declared income is less than €23,923, the CA is calculated on the percentage of the difference between the €23,923 and the declared income. At no point in time is the CA paid for each child less than €250 annually.

Moreover, the CA continues to be paid in respect of children between the age of sixteen and twenty one years where the child is either (a) still attending full time education and is not receiving any stipend or remuneration; or (b) the child is registering for his or her first employment under Part I of the Employment Register. It is also to be noted that no income tax is paid on CA received.

The WG is of the considered opinion that the CA allowance system is reformed so that it becomes a vehicle to finance, from a child's birth, a pensions account for the said child.

In part, the creation of a Child Pensions Account financed from the CA would secure a far more faithful application of the child's "right" as established under the Social Security Act as the CA would safeguard, in part, a financing of the child's life cycle. In this regard saving for the child's eventual retirement age.

A proposed Child Pensions Account system could be designed on the following parameters:

- Child Pension Accounts are opened by the Ministry of Social Policy for each child in Malta. The Ministry should seek to leverage, either by means of tendering or negotiation with the banks, the breadth of the scheme in order to obtain the optimum interest rates; bank charges et al.

- that, on the basis of the means of the parents of the Child, a part that should range from 10% to the full amount of the annual Children's Allowance is automatically deposited in the Child Pension Account.

- that there is no withdrawal of funds from the Child Pension Account unless in the event of the death of the child, where the Account is inherited by the next of kin.

- that the Child Pension Account will fall under the ownership of the child when he reaches 18 years of age.

- that the Child Pension Account will be transformed into a private pension account that is identified by the owner but the funds will not be released to the owner but would automatically be transferred to the pension instrument selected.

- that the Child Pension Account would not be accessible before the person reaches retirement age: that is, 65 years of age.

The adoption of the proposed reform to the CA system would signify a re-design of existing social benefits directed to address new problems that future generations in Malta will face. Moreover, the introduction of such a measure aims at protecting and safeguarding the child's future interest and serve to install a mentality towards savings.

It is pertinent, however, to underline that a virement of 25% of the CA onto a Child's Pension Account as against the use of such a benefit to meet expenses in bringing up a child will have, at least with low income families, an impact on their purchasing power and consumption measures.

Recommendation 10
The Working Group recommends that the Children's Allowance benefits scheme is reformed so that, in accordance to the means of the parents, a range staggered between 10% to the full said annual benefit is automatically deposited in a Child Pension Account scheme owned by the Department for Social Security is designed on the basis of the principles proposed in this Report and is competitively introduced within financial banks by not later than 1st January 2011.

In order to incentivise an accelerated accumulation of the capital within a Child Pension Account, it is proposed that contributions of not more than €500 annually per child made by the parents, relatives and other designated contributors should be subject to tax relief.

Recommendation 11
The Working Group recommends that, in order to incentivise accelerated accumulation of capital within the Child Pension Account, contributions of not more than €500 annually per child made by parents and other designated contributors should be subject to tax relief.

04.2.3 Enabling for the Introduction of Occupational Retirement Pension Schemes

As discussed earlier, the VSP scheme that the WG recommends that Government should introduce is, as a matter of principle, designed to exclude an employer from placing a mandatory contribution in the VSP for every employee within his or her organisation that opts to remain within the scheme.

The rationale adopted by the WG is that contributions to an Occupational Retirement Pension (ORP) by an employer should only take place in the event that that the employer, acting as a 'model employer', voluntarily introduces such a scheme. In such an event, the type of ORP scheme that the employer will introduce will be subject to the manner in which the scheme is designed and introduced within the relevant regulatory framework.

Thus, for example, an employer may decide to pay a contribution to every employee that does not opt out from the VSP; or he may decide to pay a contribution for each employee irrespective of whether the employee has opted out of the VSP.

Recommendation 12
The WG recommends that payment by an employer of contributions to a Second Pension should only occur in the event that an employer voluntarily introduces an Occupational Retirement Pension scheme for the employees of the entity for which he or she is responsible.

Moreover, the representing Union and the employer may agree, following collective bargaining on a new Collective Agreement, to introduce an ORP scheme for employees within that particular entity. In this regard, such an ORP scheme would be managed in terms of contributions to be paid by the employer and the employees by the parameters of the Collective Agreement and within the relevant regulatory framework as may be applicable.

The WG proposes that matters such as whether employees who would have not opted out from the VSP and whether the contribution they invest in their VSP pension account as well as the capital being accumulated in the pension fund should be matters that are discussed between the employees and the representative, and subsequently between the Union and the employer when discussing the setting up of an ORP scheme under a collective bargaining process.

Recommendation 13
The representing Union and the employer may agree, as part of the collective bargaining process on a new Collective Agreement, to introduce an Occupational Retirement Pension scheme for the employees within the respective entity; where such scheme would be managed in terms of the parameters agreed in the Collective Agreement subject to the relevant regulatory framework as may be applicable.

The establishment of a voluntary ORP would be within the regulatory parameters established in the appropriate legislation by the competent regulatory body.

The WG propose that the appropriate legislative instrument would provide for an Autonomous Pension Fund (APF) which would be regulated under conditions that include that APFs:

- are independent legal entities that are different from insurance undertakings and other financial institutions, forming a pool of assets bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits.

- are segregated from the employer or the asset of the member or service provider so that the employer or the service provider cannot get at the funds and that the funds cannot be used for any other purpose.

- members have a legal or beneficial right or some other contractual claim against the assets of the pension fund.

- can take the form of either a special purpose entity with legal personality and capacity administered by an internal governing body or a legally separated fund without legal personality and capacity administered by an external governing entity such as a pension fund manager.

Further to the above, the WG is also of the considered opinion that the OPR can also be established under the Insurance Business Act (IBA).

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

Recommendation 14
The Working Group recommends that Second and Third Pillar Pension Schemes are to be established as Autonomous Pension Funds under the Special Funds (Regulation) Act or as Pension Insurance Contracts under the Insurance Business Act.

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

The PWT are of the considered opinion that the SFA should **not** be amended to allow for the setting up of ORP schemes as a NPF.

Recommendation 15
The Working Group recommends that the Malta Financial Services Authority should **not** amend the Special Funds (Regulation) Act to allow for the setting up of Occupational Retirement Pension schemes as a Non-Autonomous Pension Funds.

In establishing the governing framework for ORP schemes the WG is of the considered opinion that the MFSA should not limit the choice of pension instruments – whether under the SFA or the IBA - that the Union and the employer may negotiate and agree to introduce for their employees. .

Nevertheless, the WG believes that Unions and employers, when embarking on discussion and negotiations to introduce an ORP, should be cautious in deciding that such an ORP scheme should be based on a DB scheme.

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

Recommendation 16
Whilst the Working Group is of the considered opinion that the relevant Special fund Act and Insurance Business Act respectively should not restrict the type of pension instruments upon which an Occupational Retirement Pension scheme is designed it cautions that employers and employees should be fully recognisant of the resulting limitations that a Defined Benefit Scheme may have on the employer prior to a decision of adopting such a scheme.

A particular concern, in terms of establishing ORP schemes, relates to micro and small and medium enterprises (SMEs) which constitute the overwhelming majority of enterprises in Malta. The establishment of an ORP scheme by a micro or SME which employs less than 50 persons may result in too high an overhead vis-à-vis the administration of the scheme. This means that, with the exception of the small number of firms in Malta that employ more than 50 persons, the majority of enterprises in Malta would shy away from introducing an ORP scheme for their respective employees.

The WG is of the considered opinion that trader and employer representatives as well as other constituted and professional bodies should give serious consideration to the ORP schemes directed to aggregate body of persons they represent (including their employees).

In essence, this would mean that members of trader and employer representatives, together with professional bodies that employ 50 persons or less would be able, should they so wish or as a result of the collective bargaining process, to offer an ORP scheme to their employees in a manner that would ensure maximisation of economies of scale in relation to the overheads to administer each respectively ORP scheme.

Recommendation 17
The Working Group is of the considered opinion that, trader and employer representatives together with professional bodies should consider introducing Occupational Retirement Pension scheme that would be able to offer to their members (and their respective employees) in a manner that would ensure maximisation of economies of scale in relation to the overheads to administer.

The WG, however, is cognisant of the fact that neither of the trader and employer representatives or the professional bodies represent in totality entrepreneurs, retailers, traders, industry and professionals. There is no doubt that there will be a percentage of employers that employ less than five people who, for whatever reason, may decide to opt out of any OPR scheme set up by a representative body.

Micro and SMEs are more susceptible to financial and cash flow problems in times of economic turmoil than larger entities. In this regard the WG expresses concern that the establishment of an OPR by a firm employing less than five members would result in excessive overheads in the administration of such a scheme as well as potential exposure to the members' contributions in the event that the employer finds himself in financial difficulties.

It is to be noted, that the EU Pensions Directive (2003/41/EEC) provides the option for insurance undertakings to carry out ORP related business. In essence, a PIC is a specific pension plan contributions to an insurance undertaking in exchange for which the pension plan benefits are paid when the members reach a specified retirement age or on earlier exit of members from the plan – if this is allowed.

Recommendation 18
The Working Group, whilst noting that it would be up to the respective employer of a firm employing less than 5 persons to determine the type of Occupational Retirement Pensions it seek to introduce, recommends that choice of the said scheme should be cost driven.

Subsequent to discussion above, the WG recommends that the MFSA should remove the existing exemption on the setting up of ORP schemes by an entity employing less than five members. The removal of this exemption, thus, would allow the possibility of an employer employing less than 5 persons to establish an OPR under the SFA.

Recommendation 19
The Working Group recommends that the Malta Financial Service Authority amends the Special Funds (Regulation) Act to remove the exemption that prevents a firm that employs less than five members from setting up an Occupational Retirement Pensions Scheme under the said Act.

04.2.4 Creating a Fast Track Route to Individual Private Pension Accounts

The PWG, in its Final Report, had proposed that persons who today have already voluntary decided to invest in a particular type of financial services product which are subject to an annual premium should be provided with the option to decide whether they wish to lock such products into an individual private pension scheme upon their maturity.

The financial services products that can be considered for conversion into an individual private pension scheme are shown in **Table 08** below. As can be seen from the table there is a considerably large number of individuals who have voluntarily invested in such schemes. Holders of endowment accumulated with profits financial products amount to slightly over 50,000 persons – where such schemes have a benefits value of over €600m.

Table 08: Insurance Contracts / Products Proceeds which can be Locked into Pension Instruments: 2007

Product Type		No of Policies	Amount of Benefits €000's
With-profits non linked	Endowments	1,640	27,431
Non-profits non-linked	Endowments	520	2,152
Non-profits non-linked	Convertible Term Assurance	563	23,884
Accumulated with-profits	Endowments	50,139	636,287
Property linked contracts	Unit-linked	24,033	N/A
Index linked contracts	Capital Redemption	409	6,170

Note: The reported amount of benefit under unit-linked products is the life element, under which benefits is given upon death of the policyholder should this occur before maturity and if the nominal value of units is less than a pre-specified minimum amount when death occurs. The amount which could be locked into an annuity upon maturity is the investment element of unit linked products which is an unknown amount.

Source: Malta Financial Services Authority

It clearly emerges that the introduction of an option which allows holders of such financial products to choose to roll over the proceeds locking them into an individual private pension scheme, on maturity, until a person reaches retirement age could have a significant positive impact in accelerating the process of introducing savings for retirement in private pension schemes within the short term – and doing so in a manner that will have a neutral economic impact.

The introduction of such a scheme should be based on the following principles:

- that a person decides whether to take the full surrender value of his of her financial services product or whether he or she locks proceeds for a private pension plan and subsequently rolls over the plan on maturity until he or she reaches retirement age where-in the surrender value is directed towards a private pension plan.
- that a person has the option to withdraw as a lump sum up to a maximum of 25% of proceeds upon retirement age where-in the person locks the remaining 75% within a private pensions plan.
- that in the event that, at any later stage, the Government introduces a mandatory Second Pension the annual premium paid on the financial product would constitute all or part of the mandatory contribution set.
- that in the event of the death of the individual, the next of kin would have the option:

- to liquidise the scheme in the event the such death occurs during the period of rolling over the financial instrument; or

- to continue to receive the pension in the event that is locked within a private pension scheme.

Recommendation 20
The Working Group recommends that the Malta Financial Services Authority introduces, by 1st January 2011, a scheme, based on the principles proposed in this report, that will allow the holder of an insurance contract / product such as a life endowment policy to roll over such a contract upon its maturity until the retirement age where-in it is subsequently locked into a private pension scheme..

The WG recognises that such a scheme will only succeed if it is supported by an attractive fiscal incentive regime. In this regard the WG recommends that the Government should introduce an incentive scheme designed on the following principles:

Maturity Before Retirement Age	**Insurance Contract / Product Locked and Rolled-Over**	**Income Generated**	**Upon Maturity prior to lock into a Private Pension Plan**	**Private Pension Plan generated income or annuity**
On decision to lock the Insurance Contract / Product proceeds on retirement into a private pension plan	Contribution until maturity of product on retirement age Tax Free	Tax Free	Tax Free The impression that such an instrument is today tax free is not correct as the Insurance Company pays the Government 15% income tax from the proceeds of the instrument prior to surrendering the proceeds to the contract owner.	15% on income or annuity generated.

Recommendation 21	
The Working Group recommends that adoption of a fiscal incentive scheme to spur up-take to the locking of Insurance Contract / Products proceeds into a private pension scheme when a person reaches a retirement on the basis of the following principles:	
Maturity Before Retirement Age	On decision to lock the Insurance Contract / Product proceeds on retirement into a private pension plan.
Insurance Contract / Product Locked and Rolled-Over	Contribution until maturity of product on retirement age Tax Free.
Income Generated	Tax Free.
Upon Maturity prior to lock into a Private Pension Plan	Tax Free (The impression that such an instrument is today tax free is not correct as the Insurance Company pays the Government 15% income tax from the proceeds of the instrument prior to surrendering the proceeds to the contract owner.)
Private Pension Plan generated income or annuity	15% on income or annuity generated

04.2.5 Leveraging Mortgage Investment in Home Ownership into Individual Pension Accounts

It is pertinent to note that the 2005 Census shows that, between 1995 and 2005, the total number of private households increased from 119,479 in 1995 to 139,178 in 2005. In this regard home ownership increased from 68.0% in 1995 to 75.2% in 2005. Moreover as is shown in **Table 09** below, the number of mortgages continued to increase in 2006 and 2007 – although the growth of rate in total lending for mortgages decreased from 21.16% in 2005 to 16.33% in 2006 and continued to decrease in 2007 to 13.84%.

Table 09: **Number of Mortgage Accounts: 2003 - 2007**

Year	Number of mortgages (accounts)	Total amount in Lm ('000s)^	Interest Rate (%)
2003	38,538	442,245	4.47
2004	41,981	539,092	4.30
2005	44,990	653,136	4.49
2006	47,055	759,837	4.95
2007	48,516	865,005	5.39

Note: ^stock value.

Source: Central Bank of Malta

Thus, whilst limited published data for savings shows a declining trend in the savings ratio over the recent years, this decrease seems to have been counter balanced by the mortgages issued by a household. Furthermore, the mortgages issued constitute a considerable proportion of the total income gained by a household. **Table 10** shows that, for 6,478 households, the mortgage constitutes 35.02% of their annual income; for 5,803 the mortgage constitutes 31.37% of their annual income; and for 2,884 the mortgage constitutes 15.59% of their annual income.

Table 10: Percentage of Mortgage on Annual Household Income

(annual loan payment) Deciles	Number of households	Total income	Total loan	Percentage in each decile	Percentage of households
missing	732	4,217,721			3.95
0-10	6478	66,897,183	4455047	6.7	35.02
11-20	5803	48,060,631	7409042	15.4	31.37
21-30	2884	19,813,788	5061327	25.5	15.59
31-40	1422	8,648,917	3102341	35.9	7.69
41-50	565	2,670,822	1217286	45.6	3.05
51-60	274	1,487,847	839514	56.4	1.48
61-70	95	523,855	329963	63.0	0.51
71-80	89	233,261	177109	75.9	0.48
81-90	83	189,698	158070	83.3	0.45
91-100	75	151,240	170981	113.1	0.40
Total	18500	148677246	22920685		100.00

Source: Proposals to Increase Housing Affordability in Malta: Report Prepared for the Building Industry Consultative Council, Professor Joseph Falzon, 2007

Table 11 below shows the behaviour of mortgage lending between 1985 and 2007. It is immediately clear from the data that lending for the purchasing of housing by means of mortgages increased exponentially during the period under consideration.

Table 11: Lending for Mortages

	Lending for Mortgages €m
1985	87,798
1990	180.126
1995	308,779
2000	600,845

2002	855,168
2005	1,521,400
2007	2,014,900

Source: Central Bank of Malta and National Statistics Office

The conclusions reached by the WG with regards to the analysis discussed are the following:

- the mortgage seems to be substituting savings by households;
- the payment of the mortgage constitutes a considerable part of a household's disposal income.

In essence this means that, to the large majority of persons, the ownership of a home constitutes the main asset of a household – with income invested in the payment of the mortgage over the period that the mortgage is to be paid.

It also means that, for a considerable number of households, the remaining disposable income following the payment of a mortgage may be such that they would find it difficult to voluntarily invest in a private pension in order to boost the income that would be available to them over and above the PAYG pension once they retire.

Hence, a most likely outcome under a *ceteris paribus* scenario is that a considerable number of persons will, on their retirement, end up with an asset portfolio that consists of a fully owned home but limited liquid savings.

Can wealth invested in a property, however, become a suitable source of retirement income? One primary way property can be used to increase or fund income during retirement is through the sale of the house: although this would mean that a person will have to finance a new, potentially, smaller home or in the event of functioning rental market rent a property.

It is, however, pertinent to underline that a number of countries have introduced financial services products know as equity release mechanisms which enable a home owner to draw down some of the equity in the property. The HM Treasury defines equity release plans as:

> "Financial products, or sale and lease arrangements, that allow home owners to release the value of their property above any amount owed on a mortgage. These schemes involve a provider giving the home owner either a lump sum or income (or both) on the basis of the value of the home. Providers receive their returns when the home is sold or vacated".[27]

There are two main types of equity release plans: (a) Home Reversion Schemes; and (b) Life-time Mortgages / Mortgages-Backed Equity Release Plans. These are discussed in detail in Appendix I to this report.

The WG is of the considered opinion that the provision of a regulated equity release plan as a further option to a person nearing retirement or who has reached retirement to allow him to boost his retirement income without the need to sell his property during his and his spouse's lifetime should be studied for implementation by Government. Furthermore, it is being recommended that the study on the introduction of regulated equity release products is finalised by end 2010 and that the study looks at:

- whether a specific legal framework would be required and whether amendment to the law of succession is required.

[27] Use of Property for Retirement, Technical Team to the Pensions Working Group, May 2009

- the design of a regulatory regime that would ensure the proper conduct of business by entities providing such products as well as securing robust protection of consumers.

- the implication of equity release products in relation to taxation and succession duties.

Recommendation 22
The Working Group recommends that the provision of a regulated equity release plan as a further option to a person nearing retirement or who has reached retirement to allow him to boost his retirement income without the need to sell his property during his and his spouse's lifetime should be studied for implementation by the Government – with the study, which should be competed by end 2010, to look at: - whether a specific legal framework would be required and whether amendment to the law of succession is required. - the design of a regulatory regime that would ensure the proper conduct of business by entities providing such products as well as securing robust protection of consumers. - the implication of equity release products in relation to taxation and succession duties

04.3 Incentivising Saving for Voluntary Pension Retirement Schemes

The challenge of the pensions reform framework initiated in 2004 and under continued review through this report is that of securing a balanced pensions framework that not only simply ensures a universal minimum standard of living for persons in retirement. Rather, the pensions framework must seek to minimise the gap between the pension received and the average wage paid over time so that a retired person's standard of living remains, to the extent possible, at least in sight of that enjoyed during his or her working life. This, however, is to be achieved within a sustainable pension financing economic framework.

The recommendation of this report is that, given the current cyclical economic conditions, further structural reform of the pensions' framework should be deferred until appropriate economic conditions that will enable for the absorption of shocks stemming from such reform are reached.

The report, however, further recommends that in the interim, the Government should introduce a voluntary Second and Third Pillar Pension framework that will enable persons, who wish to decide to invest in savings for the retirement life cycle, to be in a position to do so.

The key concern with regards to a voluntary pensions framework where persons are faced with a choice of whether to invest in a pensions plan is that behavioural studies show that most too often people take decisions with regards to their lives on the basis of the 'here and now' as against the future – for which retirement for many persons may be decades away. Inevitably, an end result is that persons fail to take steps to save for their future – which in turn will result that they will fail to maintain their incomes and life times after retirement particularly given that the pension replacement rate of the current PAYG pension will fall, and fall substantially, over the term of review – 2050.

A recent report issued by the Department for Work and Pensions titled 'Savings For Retirement: Implications of Pensions Reforms on Financial Incentives to Save for Retirement[28] identifies the following as real barriers to saving:

[28] Pg 37, Savings For Retirement: Implications of Pensions Reforms on Financial Incentives to Save for Retirement, Research Report No 558, Department for Work and Pensions, 2009

Inertia	Considered as a key factor that has been explored by economists. Given that retirement savings relates to something so far in the future, it is a decision that is very likely to be put off until tomorrow. The way that options are presented to individuals and the effort required in taking action can have significant impacts on behaviour.
Myopia	In contrast to economic theory, individuals are often observed spreading their financial resources over only relatively short timeframes, particularly at younger ages. Without triggers to encourage thinking about retirement and with pressing financial and other constraints, many people may focus on meeting work-age financial needs without considering their retirement saving.
Hyperbolic Discounting	Individuals do not discount the future at a constant rate, so that their preferences for future consumption are not consistently related to preferences for current consumption. This can lead to expectations for future needs not being met – people may prefer to consume more now but when they get to later life they become unhappy with their previous decisions.
Bounded Rationality	Pension decisions may be too complex for individuals to solve on their own, particularly as some individuals may have low financial capability. Thus, they make decisions that may not be fully optimal. To reduce the effort (and the cost) of making complex decisions, individuals may use 'rule of thumb' rules to help choose when and how to save.
Habits	Individuals are habitual, which can explain why people do not react to changed financial incentives, even if it would be rational and financially beneficial for them to alter their behaviour.
Loss Aversion	Individuals are also often adverse to losing money and may often accept lower positive returns in order to avoid negative ones, even if they may be risk takers when it comes to situations where there are no loss possibilities.
Herd Mentality	Individual decisions are often made by observing and copying others, particularly if this reduces the effort required to carry out a full rational analysis of all the available options.
Mental Accounting	Individuals may also follow norms of 'mental accounting' to help conceptualise their financial obligations, for example, having different savings accounts for different persons. This means that it is less easy to predict how current consumption will respond to gains in income as the result is dependent on which account the individual allocates the gain to.

It is pertinent to underline that an OECD study titled 'Coverage of Funded Pension Plans'[29] shows that coverage in funded voluntary pension plans is well above 50% in most countries considered. The study shows that in Canada, Ireland, the UK and the USA, where funded pension private plans are voluntary and the benefit coverage of public schemes is relatively low the share of persons who are members of a voluntary funded pension plan is more than half of the employed population – around 60%.

In Finland and Norway, however, where PAYG financed pensions plans provide a relative large replacement rate (similar to Malta where to date the PAYG provides the only replacement rate) coverage in a voluntary funded personal pension plans is relative low – standing at 7.3% and 3.0% respectively.[30]

[29] Antolin, P., Coverage of Funded Pension Plans, OECD Working Papers on Insurance and Private Pensions, No 19, OECD Publishing, 2008

[30] Ibid. Data source reference for Finland is 1998 and for Norway 2002.

A similar concern arises with employers contributing voluntary in an OPR scheme. It is, considered, highly unlikely that in a voluntary pensions framework that an employer will voluntarily introduce a Second Pillar Pension where the employer will match in part or in full a Second Pillar Pension voluntary contribution paid by the employee – although there may be instances where such OPR schemes are introduced as part of collective bargaining negotiations (potentially in lieu of other benefits) or because of scarcity of highly skilled personnel and hence the employer seeks to attain a competitive edge in attracting and retaining such skills.

The key instrument applied in other jurisdictions to propel employers and persons to invest in respectively setting up OPR schemes and in contributing to such schemes is to provide preferential tax treatment of pension plans compared to other forms of savings. This differentiation is of importance. The purpose of providing tax incentives to pension plans is not that of encouraging savings per se, but of promulgating an efficient size of savings for use during the retirement period of a person's life cycle.

From a government perspective, the underlying rationale of why a government should introduce such preferential tax treatment of pensions' plans is that encouraging individuals to increase their retirement wealth could be considered as action '**in the public interest**'. The financial cost to Government stemming from the cost of the incentive, the deferment of tax revenue (direct and indirect today) is more than offset by the potential burden that the future generations may face in having to finance, by means of taxes, a larger pension GDP % in order to secure an 'adequate' pension level as provided by the PAYG – the First Pillar Pension; as well as ensuring that an aged population (over 35% will be over 60 years and over) have sufficient income to stimulate the economy.

The theoretical rationale of introducing a tax advantage to a retirement saving instrument is that, in most cases, this results in a modest increase in the rate of return to that particular asset. The return is 'modest' as most tax incentives to pension saving schemes are associated with a tax referral or at most a partial tax exemption – rather than a complete exemption from taxes.

Most often, therefore, pension saving incentive schemes are designed in a manner where a person is partially exempt from taxation on income that is contributed to a given scheme (often within a certain limit) but they are subsequently taxed when those resources are drawn from the savings at retirement. Alternatively, if interest payments, capital tax gains, and withdrawals are untaxed, then contributions to such pension saving schemes are typically made out of taxed income. The former design is best expressed by the Individual Retirement Account in the USA; and the latter is that of the TESSA and ISA in the UK and the ROTH in the USA.

Table 12 below demonstrates types of tax treatment on retirement savings on the basis of 'EET' notation of deferred taxation where:

E	Tax Exempt
P	Partially Exempt / Partially Taxed
T	Taxed.

Table 12 Types of Tax Treatment on Pension Savings

	Germany	France	Italy	Spain	Netherlands	UK
	EEP	EEP	EPP	EET	EET	EET

Without seeking to enter into a complex underpinning theoretical hypothesis on the effectiveness of tax incentives as instruments to stimulate pensions saving, for such effectiveness to be achieved at least one of the following two criteria must be met:

First, personal savings must be sufficiently elastic to the net rate of return. If this is so, the higher returns provided by the tax-preferred pension plan can then produce a net flow of additional savings. The degree of savings elasticity is an empirical issue, since economic theory based on the traditional life cycle hypothesis cannot provide insight into the size or direction of this relation.

The idea itself of a general interest elasticity of saving can hardly be conceived in a behavioural context if the usual prerequisites of complete rationality in intertemporal decision making, full information, and the self control of the individual in carrying out plans that mean the fore-going of short term decisions relating to one's quality of life.

Second. Tax incentives should be capable of influencing the portfolio decisions of savers, inducing them to replace taxed with non taxed assets. If there is perfect substitutability among different assets, then even a small spread between returns induced by a tax incentive will lead to the complete substitution of forms of savings.

The key issue that arises in this regard is whether the degree of the increased savings in pensions' retirement schemes is truly 'new' savings – deferred from consumption behaviour – as against a substitution savings from existing savings instruments into the new incentivised pensions' retirement schemes.

There is a wide array of economic studies that seek to determine the effectiveness of the application of tax incentives to stimulate retirement savings. A review of such studies shows that assessment of the economic effectives of such instruments is contradictory – in part as such assessments are country specific.

For example a study carried out by the Centro do Analisi delle Politiche Pubbliche on the role of tax incentives in voluntary pension schemes in Italy which is based on an EPP framework concludes that "tax incentives alone are not the most effective instrument with which to promote pension saving plans, particularly if the target cohorts include poorer, younger people faced with liquidity constraints".[31]

An OECD study on the Riester tax-favoured voluntary retirement savings introduced in 2001 concluded that not sufficient time had passed to make a conclusive assessment. Nevertheless it adds that:

> "The paper unfortunately adds little to the core question, whether tax relief creates additional new savings … While we do know that subsidies strongly increase saving in the specific form that is subsidised, possibly to the detriment of other saving forms, we do not really have firm evidence that saving related tax relief or similar subsidies increase total saving in Europe.
>
> This does not make tax relief a potentially wasteful instrument. Even if a tax relief would only shift other saving to retirement saving, this may be a valuable mechanism if the government wants to make sure that the elderly will have a generous multi-pillar retirement income. That is, if the government does not believe in the creation of new saving for macroeconomic purposes, it still may want to repress procrastination not only in form of consumption now, but also in the form of a larger house in the near future, and subsidise retirement consumption in the far future."[32]

A different study by OECD which looked at the tax incentives introduced for the IRAs in the USA and the Tax Exempt Special Savings Accounts (TESSAs) and the Individual Savings Accounts (ISAs) in the UK "suggests that, at the most, only relatively small fractions of the funds going into tax-advantaged savings vehicles can be considered to be 'new' savings'". The study adds:

> "As such, the best interpretation of the evidence is that such policies are expensive ways of encouraging savings. In addition, to the extent that the reshuffling of assets leads to a reduction in tax liabilities without any real change in economic behavior, there is some deadweight loss associated with such policies. Additionally, since those with the greatest reshuffling possibilities are the wealthier members of society, these policies will typically have some distributional impact. A priori we would expect these factors to be biggest for IRAs and TRRAs, where the liquidity

[31] Pg 9, Bosi, P., and Guerra, M. C., The Role of Tax Incentives in Voluntary Pension Schemes In Italy: What Can Other Countries Learn from This?, Paper presented to the Fourth International Forum of the Collaborating Projects on Aging Issues, Tokyo, Centro di Analisi delle Politiche Pubbliche, 2002,

[32] Pg 137, Borsch-Supan. A., Mind the Gap: The Effectiveness of Incentives To Boost Retirement Saving in Europe, OECD Economic Studies No 38, 2004/2, OECD 2005

restriction would be likely to prevent savers with low wealth from participating. As such the introduction of the ISAs in the UK is an important episode, showing, as it does, that even when such accounts do not include minimum holding periods the extent to which they encourage genuinely 'new' saving is limited."[33]

A report by the Pensions Policy Institute on behalf of Age Concern England titled 'Tax Relief and Incentives for Pension Savings' also concludes that the effectiveness of the TESSAs and ISAs pension savings tax incentive schemes is unproven given that there is no evidence that tax incentives increase the overall level of savings. It concludes that the primary reasons for this are (a) the tax incentive schemes are complex and thus difficult to understand which in turn acts as an obstacle to their take-up; (b) the tax incentives do not appeal to the right target group; and (c) the amount that people seek to save is determined by a range of factors that are not linked to tax relief or rates of return.[34]

As shown above, economic theoretical and empirical evidence on the successful impact of tax incentives to stimulate increased pension savings is not conclusive. The main argument raised in the literature reviewed against the introduction of such a scheme is that there is very limited empirical evidence that such tax incentives schemes have, in essence, created 'new' savings.

The WG, has reflected on the economic review and empirical studies and the various and different conclusions reached. The WG argues, however, that the situation in Malta is different from most countries which have been empirically studied. Malta has, to date, only one pension pillar – the PAYG. It has no voluntary Second Pillar Pension mechanism – let alone a mandatory one. Despite the lack of reliable household and savings data, indicators seem to show that Maltese are saving less – with an extent of this saving reduction being replaced by mortgage payment.

As shown earlier in this document, the GPD % deficit, as forecasted under the AWG assumptions at (7.2%), is not sustainable. The current level of (2.5%) level is generating structural economic pressures. Thus, unlike other countries, Malta is yet to build a framework that, at the first instance, provides people with the option to save for their retirement; and subsequent to this to build a culture for saving for retirement.

The building of a culture for saving for retirement will not be easy to achieve: it requires education, information, understanding of consequences, changes in habits and life style behaviour. Nor will such a change occur overnight. It will take time.

In this regard, the WG is of the considered opinion that, in embarking upon the building of a culture of savings, the Government must put together a tool-box of instruments which should include tax incentivisation in pensions savings.

In a state of play where we are yet to initiate a culture of saving for retirement, the WG is of the considered opinion that the creation of a situation where 'new' savings will be marginal at best, and that savings into pension retirement savings funds would be a form of substitution to other saving mechanisms should not be considered as an impediment to embark upon such incentivisation.

It is pertinent to emphasise that the pension savings instruments that are proposed in this report are long term instruments that 'lock' the savings made by the said person until he or she retires. This contrasts with traditional saving mechanism such as savings account and, potentially, fixed term accounts given that with such accounts the fixed term is as decided and entered into by the account holder.

Thus, if the introduction of a tax incentive framework for the pension instruments discussed earlier in this report creates a shift that substitutes savings and fixed terms saving instruments – to mention two examples – by locked pensions retirement scheme then such a scheme would have a positive spur on the building of a culture of savings and for preparing oneself for retirement period of the lifecycle.

[33] Pg 166, Attansio, O, P., Banks, J., Wakefield, M., Effectiveness of Tax Incentives to Boos Retirement Saving: Theoretical Motivation and Empirical Evidence, OECD Economic Studies No 39, 2004/02, OECD 2005

[34] Pg 11, Curry, C., and O'Connell, A., Tax Relief and Incentives for Pension Savings, Pensions Policy Institute, Age Concern England, October 2004, www.pensionspolicyinstitute.org.uk

This would be so, because persons would position their savings in locked environments for use only on retirement, rather than maintaining flexibility – potentially with a view to retain them for retirement purposes – but subject to use in the current life cycle period in accordance with behavioural decisions relating to life style choices.

Recommendation 23

The Working Group recommends that given that Malta is yet to establish instruments for saving for one's retirement let alone building a culture for saving for one's retirement there is merit that in building such a culture government puts together a comprehensive tool-box that includes tax incentivisation in pensions savings.

The WG has, in the drawing up of this report, sought to undertake macro economic modelling to determine a potential tax incentive framework for Malta that would stimulate persons to invest in the proposed voluntary pensions retirement schemes discussed in the earlier part of the report.

From a tax incentive design point of view, within the ambit of a voluntary Second and Third Pensions Pillar, there is no doubt that the introduction of such a framework should be biased towards introducing up front tax relief – at a rate that is more attractive than the 15% With Holding Tax on bank deposits – as against tax benefits upon the maturity of the pension retirement savings once a person retires.

Similarly, stimulating OPR schemes wherein an employer will match, in part or in fall, a contribution paid by an employee into the voluntary OPR scheme would require a tax incentive design that would provide tax relief from annual payment of taxation in accordance to, in part or in full, the contribution matched by the employer.

It is also argued, that an up-front tax incentive design would be required to attract persons who have already invested in endowment and other profit and unit linked policies to extend the value of these policies into a retirement savings scheme upon maturity – as against consuming such investment on matters that are not linked to his or her retirement lifecycle period.

Recommendation 24

The Working Group recommends that, within the ambience of the voluntary Second Pillar and Third Pillar pension schemes, in order to stimulate up-take in saving for one's retirement, the tax incentive instrument is to be designed in a manner that is biased towards up-front tax relief instruments as against on the maturity of such pension schemes.

The WG was not able to articulate, during the course of its work, a tax framework instrument. Although it initially sought to build such a framework on the work carried out by Hewitt Bacon Walcow Ltd it ultimately concluded that this was not possible given that the key underpinning value in this work, the value of the tax relief instrument to be introduced by Government, was arbitrarily assumed rather than reached on the basis of macro economic modelling.

In seeking to prepare a macro economic model the WG experienced two key limitations. The first is that savings data is poor – particularly given that the last Household Budgetary Survey is 2002. The WG, subsequent to considerable discussion, agreed that carrying out modelling on such data would be dangerous as the point of departure upon which strategic conclusions will be reached is flawed.

The second is that modelling responses of the effectiveness of tax incentive instruments on retirement pensions saving, as shown earlier, is dependent on behavioural responses. In this regard, the WG did not have access to a sample based response of the behaviour of persons in different age, income, et al distributions to the introduction of retirement pensions schemes and how tax incentives will affect their response. The WG agreed that in the absence of such a behavioural study any assumptions on behavioural would be at best a 'wish list' that is based on no empirical evidence.

There is no doubt, that in designing a tax incentive framework for simulating up-take in the voluntary pensions framework proposed in this report, Government should:

(i) Carry out a study on various tax incentive scenarios to model how these will affect government revenue today, consumption behaviour, savings behaviour and income deferred for consumption during retirement age.

(ii) In tandem with the above, and inputting to the above, the carrying out of a lifecycle behavioural study to model behavioural responses to tax incentive frameworks to the pension instruments as well as to gauge the creation of 'new' savings as against the substitution of savings.

The carrying out of this study is to be preceded by securing the appropriate integrity in household and savings data and in the carrying out of a behavioural study to gauge responses to a voluntary private pensions and tax incentives on the basis of a national population sample.

Recommendation 25

The Working Group recommends that in designing a tax incentive framework for simulating up-take in the voluntary pensions framework proposed in this report, Government should:

(i) Carry out a study on various tax incentive scenarios to model how these will affect government revenue today, consumption behaviour, savings behaviour and income deferred for consumption during retirement age.

(ii) In tandem with the above, and inputting to the above, the carrying out of a lifecycle behavioural study to model behavioural responses to tax incentive frameworks to the pension instruments as well as to gauge the creation of 'new' savings as against the substitution of savings.

The carrying out of this study is to be preceded by securing the appropriate integrity in household and savings data and in the carrying out of a behavioural study to gauge responses to a voluntary private pensions and tax incentives on the basis of a national population sample.

04.4 Access to Pension Plans, Vesting Rights and Disclosure of Information,

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

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

Recommendation 26

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

Although the proposals presented in this report are that under the proposed voluntary second pillar pensions employers are not mandated to contribute to OPR schemes instances may arise where the employer, either for specific internal strategic objectives, or due to an agreement reached through collective bargaining negotiation may contribute to such a scheme.

In such circumstances, the WG underlines the importance that the Department of Industrial and Employee Relations ensures that the appropriate level of protection to employees from retaliatory actions and threats of retaliation either by the employer or pension plan representative with respect to pension benefits and the exercising of rights under a pension plan is in place. Examples stated by OECD[35] include:

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

Recommendation 27

The Working Group recommends that the Department of Industrial and Employee Relations should strive to ensure ensures that the appropriate level of protection to employees from retaliatory actions and threats of retaliation either by the employer or pension plan representative with respect to pension benefits and the exercising of rights under a pension plan is in place.

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

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

[35] Pg 19, Private Pensions and Policy Responses to the Crisis – Recommendation on Core Principles of Occupational Pension Regulation, OECD, June 2009

- the protection of vested benefits of those employees who would have severed their employment with their employer and, therefore, should not be subject to forfeiture, regardless of the reasons of termination except in limited cases of dismissal resulting from acts of gross malfeasance which should be clearly defined.

- the protection of vested benefits when the employer or the pension service provider changes ownership due to merger, acquisition, or files for bankruptcy as well as from creditors of individual plan members.

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

Recommendation 28

The Working Group recommends that the Department of Industrial and Employee Relations should establish the appropriate safeguards with regards to benefit accrual and vesting rights on the basis of the OECD Implementing Guideline for Core Principle 5: the rights of members and beneficiaries and adequacy of benefits.

With regards to the portability rights of pension plan holders the WG recommends:

- a pension plan holder who decides to shift a pension plan policy from one pension service provider to a different pension plan provider should be protected from the charging of unreasonable exit fees by pension plan providers.

- an employee who changes job should be able, upon request, to move the value of the vested account benefit in a DC from their former employer's pension plan either to the plan of their new employer or to an alternative financial instrument or institution; and in doing so should not be inhibited by prohibitive and unreasonable exit fees.

- an employee should hold a portability right of his or her vested account benefit when he or she separates with an employer – whatever the reason for such termination.

- an employee should not be obliged to exercise his or her portability right when he or she terminates employment and thus should hold the right to choose to retain his or her vested account benefit with his or her previous employer.

Recommendation 29

The Working Group recommends that:

- a pension plan holder who decides to shift a pension plan policy from one pension service provider to a different pension plan provider should be protected from the charging of unreasonable exit fees by pension plan providers.

- an employee who changes job should be able, upon request, to move the value of the vested account benefit in a DC from their former employer's pension plan either to the plan of their new employer or to an alternative financial instrument or institution; and in doing so should not be inhibited by prohibitive and unreasonable exit fees.

- an employee should hold a portability right of his or her vested account benefit when he or she separates with an employer – whatever the reason for such termination.

- an employee should not be obliged to exercise his or her portability right when he or she terminates employment and thus should hold the right to choose to retain his or her vested account benefit with his or her previous employer.

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

Slovakia, for example, following the economic crisis, has strengthened legislation to demand that pension fund management entities provide more detailed information about participants' rights, fund management and results. The Hungarian Financial Services Authority has introduced a new communications strategy emphasising the importance of the disclosure of 10 year performance records including an explanation of weak returns. The UK has significantly increased communications activity via a series of public statements to employers and trustees setting out their general position in relation to current market conditions.[36]

Recommendation 30

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

04.5 Designing the Pay-Out Phase of Private Pensions

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

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

Table 13: Forms of Pay-Out Options of Private Pensions

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

[36] Pg 16, Ibid

These forms of pay-out options are discussed below:

04.5.1 Lump Sum Payments

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

Schemes can be designed to allow for advanced payments – that is, payments before retirement. In such instances the retirement focus of the saving arrangements can be diluted. Some countries allow full or partial premature withdrawals in a variety of circumstances such as house purchase, serious disability, etc. Countries that allow for partial pre-retirement withdrawals include Mexico (10% only on marriage and unemployment); Switzerland (house purchase); and Singapore (death, disability, housing, education).[37]

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

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

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

04.5.2 Programmed Withdrawals

Programmed withdrawals consist of a series of fixed or variable payments whereby the annuitant draws down a part of the accumulated capital (and continued earnings there on). The key word is 'programmed' – thus implying more discipline than the less structured erosion of a lump sum. Programmed withdrawals do not involve longevity guarantees that would require complex actuarial reserving and solvency margins. They are financially uncomplicated. There is no cross-subsidy from those who live for only a short time in retirement to those who live longer than the expected average. Programmed withdrawals thus also address the basic bequest motive.[38]

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

(a) Present value of a life annuity – where the retirement capital is divided by an equivalent life annuity. Calculations may be performed only once and thus the pension payments will be constant or the calculation may be repeated every year which results in a constant re-spreading of the remaining, declining capital.

[37] Pg 6, Antolin P., Pugh C., and Stewart F., Forms of Benefit Payment at Retirement, OECD Working Papers on Insurance and Private Pensions No.26, OECD Publishing, 2008
[38] Pg 8, Ibid

(b) Life expectancy – where the retirement capital is divided by the expected future life expectancy of the annuitant. Here too practice differs as to whether the calculation is made only once at the beginning or annually throughout the individual's lifetime.

(c) Annuity certain to an advanced age – where an advanced age beyond the average life expectancy (Canada for example allows an annuity certain to age 90) is taken for calculation purposes in order to avoid frequent depletion of the retirement capital.[39]

There are many variants within this theme – which include:

Totally Prescriptive Formula.

Both Minimum and Maximum Limits.

Only Minimum Payment Requirements..

Annuity Certain.

Programmed withdrawals are more constraining compared to lump sum payments though less constraining than purchasing a life annuity. Moreover, in a similar manner to lump sum payments, programmed withdrawals satisfy the 'bequest' motive', whereby any balance remaining at the retiree's death is payable to the individual's estate. Furthermore, the capital of programmed withdrawals schemes continues to be invested in the pension fund and thus continues to earn a rate of return.[40]

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

It is pertinent to note that whilst programmed withdrawals are present in a considerable number of jurisdictions, the UK is very cautious in its advice to individuals regarding such arrangements – making a strong case for a person to choose a traditional life annuity and view present programmed withdrawal products as being suitable only for well-off individuals with considerable amounts of retirement capital.[41]

04.5.3 Life Annuities

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

The main advantage of life annuities is that the payments are fixed and are made for the entire lifetime of the retiree. The payments in the first year are the same under a life annuity and under a programmed withdrawals based on the present value of a life annuity. During the ensuing years, however, retirement payment from programmed withdrawals, as explained earlier, slowly declines in comparison to life annuities. With regards to programmed withdrawals using life expectancy as the denominator, retirement payments actually increase over time – though they never reach the levels of a life annuity.[42]

[39] Pg 9, Ibid
[40] Pg 11, Ibid
[41] Pg 12, Ibid
[42] Pg 13, Ibid

It is pertinent to note that life annuities involve the retiree foregoing future control over investments and losing the potential to earn superior investment returns. It also runs counter to the bequest motive – and thus provides for no protection to the retiree's spouse, partner or other dependents after his or her death. Moreover, under the conventional single life annuity the pension payments stop immediately upon the retiree's death. Thus, if the retiree is unfortunate enough to live for a very short period after his retirement the expenditure of a large amount of capital on the purchase of an annuity will, undoubtedly, be perceived as an extremely poor investment. Under a single life annuity the retiree's entire accumulated retirement capital is transferred to an insurance company that invests the money for the aggregate support of its entire portfolio of annuity business, and not for the individual account of the pensioner. One other limitation of the single life annuity is that it does not provide protection against inflation[43].

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

- Escalating Life Annuities.
- Variable Annuities.
- Deferred Annuities and Longevity Insurance.
- Joint and Survivor Annuity.
- Contingent Annuity.
- Full Cash Refund Annuity.
- Modified Refund Annuity.
- Life Annuity with N Year Guarantee.
- Modified Refund Annuity.

It should be noted in most advanced societies insurance companies are the sole providers of life annuities. OECD states, however, that the number of insurance companies interested in selling annuities has fallen dramatically in recent years in "some markets that would normally be categorised as mature and well developed – a primary reason being because life annuity business can be particularly uninteresting or even unprofitable (low investment returns and increasing longevity, coupled with high reserving requirements).[44]

04.5.4 Combined Arrangements

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

The WG, following a review of the different policy options that may be introduced with regards pension benefits payment upon retirement, believes that the policy instrument should differentiate between a pension retirement benefit resulting from a Second Pension (even though voluntary) and a Third Pillar Pension.

[43] Pg 14, Ibid
[44] Pg 26, Ibid

With regards to the Second Pension the WG concludes that the pension benefits stemming from the Voluntary Second Pension or a Child's Pension Account or a conversion of life or profit based policy into an Individual Pension Account or through the introduction of an ORP should be on the basis of a combination arrangement that incorporates a lump sum withdrawal and a purchase of an income generating option. The WG recommends that the combination arrangement should reflect the following:

- the flexibility to withdraw a maximum of 25% of the accumulated capital (including pro-rated earnings) as a lump sum.

- the mandatory purchase of annuity income generating option with the remaining 75% of the accumulated capital (including pro-rated earnings) where the retiree would be provided with the opportunity to select the insurance company from whom he will purchase the income generating option.

Recommendation 31

The Working Group recommends that pension benefits stemming from the proposed Voluntary Second Pension framework as well as with Third Pillar Pensions should be on the basis of:

- the flexibility to withdraw a maximum of 25% of the accumulated capital (including pro-rated earnings) as a lump sum.

- the mandatory purchase of an 'income generating option' with the remaining 75% of the accumulated capital (including pro-rated earnings).

With regards to the 'income generating option', the WG believes that the option selected for the Second Pillar Pension payment benefit framework should not be a simple single life option. As discussed earlier, such an instrument fails to provide for the continued payment of a pension benefit to the qualified dependent following the death of the retiree.

The WG is, therefore, of the considered opinion that the instrument that should be selected and regulated for the voluntary Second Pillar Pension Scheme should be such that provides for continued benefit payment to the qualified dependent of the retiree.

With regards to a Third Pillar Pension Scheme it would be at the discretion of the person to determine the type of scheme and benefit payment he or she decides to opt for.

Recommendation 32

The WG recommends that the income generating option that is to be regulated by the appropriate legislative framework is with regards to the:

(a) Second Pension (Voluntary Second Pension) Framework benefit payment should preferably be such that it provides for continued benefits to the qualified dependent of the retiree.

(b) is with regards to the Third Pillar Pension at the discretion of the benefit scheme and benefit payment that he or she will select.

In this regard, the WG recommends that the Government carries out a study, by 1st September 2010, to determine amongst existing complex instruments (such as Joint and Survivor Annuity; Contingent

Annuity; Full Cash Refund Annuity; Modified Refund Annuity) the appropriate complex retiree and spouse income generating instrument that shall be introduced for Second Pension schemes.

Recommendation 33
The WG recommends that Government study, by 1st September 2010, a determination of the income generating instrument (including annuity schemes) that shall be introduced for the Second Pension.

04.6 Save-guarding the Pension Funds

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

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

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

It is to be noted, however, that arguments exist against the setting up of PFPS. One key argument is that a PFPS creates a 'moral hazard' – in that, if an employer knows that upon bankruptcy their defined benefit pension fund liabilities will be covered, even if sufficient assets are not available to back this promise, the employer could be incentivised to indulge in irresponsible behaviour, leaving others to cover the costs of the pension promises they would have made or agreed to as a result of collective bargaining with the Unions. Responses to this risk include the placement of a limitation on the pension benefit covered such as the Ontario fund, or through the imposition of strict funding rules in order to limit the size of the potential claim made on the PFPS.[45]

The second argument against the setting up of a PFPS is what is termed as 'adverse selection' – in that if when the premium rate is set due consideration is not taken of the contributing firm's bankruptcy risk, pension funding level and investment policy, stronger member firms will inevitably end up subsidising weaker ones as a PFPS will provide protection to members of a DB scheme in the event that the employer is rendered bankrupt. If these cross subsidies are too high, the problem of 'adverse selection' kicks in as financially secure firms find ways of pulling out of a guaranteed system – with employers withdrawing from providing DB schemes and replacing them by DC schemes[46].

There is one important function that PFPS do not do: they do not provide protection against the market risk in defined contribution schemes. Thus, the reduction of 20% to 25% of the value of pensions funds discussed earlier in this report will not be compensated, in part or in full, by a PFPS. A person who is on a DC pension scheme and who retires in 2009 will definitely have access to a far lower accumulated capital to purchase a life annuity than if he or she would have retired in 2007 before the event of the economic and financial crisis.

[45] Pg 6, Stewart, F., Benefit Security Pension Fund Guarantee Schemes., OECD Working Papers on Insurance and Private Pensions, No 5, OECD Publishing, 2007
[46] Pg 6, Ibid

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

In this regard the WG is of the considered opinion that, within the ambit of the recommendations it proposes in this report, the introduction of appropriate levels of protection, whether these are in the form of robust funding rules, or asset liability matching or priority insolvency rights or the constitution of a Pension Protection Fund, should be introduced. The WG thus recommends that the Government should carry out a study by 1st September 2010 wherein it will present recommendations for the setting up of a protection regime that will safeguard pension contributors against insolvency, misappropriation and fraud.

Recommendation 34

The Working Group recommends that the Government carries out a study by 1st September 2010 wherein it will present recommendations for the setting up of a protection regime that will safeguard contributors to Second Pillar Pension against matters such as insolvency.

04.7 Securing the Lowest Cost of Administration Charges to the Lowest Level Possible

A review of the fees structure that pension providers charge in different jurisdictions shows that this is a complex issue. Fees can be either fixed or variable. A fixed commission is characterised by the fact that the price does not depend on the level of the salary or on the size of the fund. A variable commission may take the form of a percentage of the flow, of either payments or contributions, or of the stock, as a percentage of the amount managed or as a percentage of the cumulative assets turnover – where a variable commission on the flow (normally shown as a % of salary) is the most common.[47]

Variable commission on stock can either be on the value of the fund or on returns. Variable commission encourages pension companies to maximise assets by maximising returns. A potential danger with this type of commission is that it may encourage a pension provider to adopt investment strategies which are profitable in the short term but may be detrimental against the fundamental goal of maximising results in the long term in order to guarantee subscribers an adequate pension – an accusation levied at financial institutions that has been heard often during 2009 in the wave of the financial and economic crisis.

Additionally, pension companies may also charge exit fees when workers transfer their individual accounts to another pension provider. This could be countered by rules with regards to transfers.

Different jurisdictions adopt different structures for charges and balances between fees on contribution and asset management fees. Australia provides for a fixed commission, fees on contribution, fee on asset, and a switching / exit fee. Sweden, on the other hand, provides only for a fee on assets.

It so follows, that the higher the fee that pension providers charge and the higher the administrative cost for the management of the fund the higher is the negative impact on the retirement income of participants in that fund. The question therefore is: should there be a ceiling on the maximum fee that can be charged or should this be established by competition?

Poland, for example, has successfully introduced price caps to lower fees. Prior to 2004, the management fee was subject to an upper limit of 0.6% of individual account balances, whilst contributions fees were not capped. In 2004, changes were introduced to cap both the management fee (0.54%) and

[47] Pg 4, Tapia, W., and Yermo, Y., Fees inn Individual Account Pensions Systems: A Cross-Country Comparison, OECD Working Papers on Insurance and Private Pensions, No 27, OECD, 2008

the up-front fee (7% to be reduced to 3.5% by 2014). Further limits were placed on the management fee related to the overall size of assets under management - with the fixed component of the management fee to be lower than 0.045% of net assets, while the variable component of the management fee limited to a maximum of 0.005% of net assets per month.[48]

In Sweden, on the other hand, whilst there are no limits on fees, fund managers are obliged, under the agreement between them and the Premium Pensions Authority, the public clearing house of the system, to offer a rebate on their ordinary fees for retail investors.

The fee levels in different jurisdictions vary. In the Slovak Republic the net fee on contributions is 0.09% and the fee on assets is 0.85%. In Sweden the fee on assets ranges from 0.42% to 1.21% whilst in Australia this ranges from 0.7% to 2.53%. In 2007, the administrative charges as a % of total assets stood as follows[49]:

Table 14: Administrative Charges as % of Total Assets, 2007

%	Country
0.48	Sweden
1.25	Australia
1.25	Latvia
1.52	Estonia

Source: OECD

The differences in the fee structure between one country and the other is primarily determined by the maturity and size of the system, asset allocation and investment regulation, competition amongst pension providers.

In this regard, the Working Group is concerned that the administrative charges for the management of a voluntary Second Pension framework as proposed by it may result in a high charge on the administration of the pension funds given that:

01. Malta is a small market, and the introduction of a Second Pension framework on a voluntary basis, even if this is based on an 'opt-out' basis as proposed, will result in a reduced number of participants within what already is a small contributory population.

02. An open approach to competition, as proposed by the PWG, may result in a situation where either there is little response by the private sector to participate in this market which may result in a private monopolistic or duopoly market or potentially the participation of a high number of private sector providers which may subsequently result in market adjustment which may negatively impact those participants with providers who may be forced out of the market.

The WG is of the considered opinion that a voluntary Second Pension framework will only be viable if the fees charged by private pension providers are such that they will only marginally reduce the retirement income of participants. A study by the UK Department of Work and Pensions (May 2006) shows that under a 1.5% management charge, an individual saving for 40 years will lose around 20% of pension compared to a charge of 0.5%. In fact the UK Pensions Commission suggested that there could be an annual management charge of 0.3 per cent in the long run.

[48] Pg 7, Ibid
[49] Pg 11, Ibid

The WG notes the OECD conclusions that the "cost advantages of the Swedish and Bolivian systems stems largely from a decision to force cost competition among providers via a central agency or 'clearing house'"[50] The WG is not, as this stage, in a position to determine whether the approach adopted by Sweden is an approach that can be replicated in Malta: given the limitations of specialised skills.

Thus, the WG recommends that Government should carry out a review on the mechanism that Malta is to adopt in ensuring that the appropriate administrative cost structure maximises in terms of economies of scale. Such a review would evaluate, amongst others the:

- introduction of a fee capping structure; or
- establishment of a central agency to act as a clearing house.

Recommendation 35
The WG recommends that Government should carry out a review by June 2010 on the mechanism that Malta is to introduce to ensure that the appropriate administrative cost structure maximises in terms of economies of scale, Such a review would evaluate, amongst others the: - introduction of a fee capping structure; or - establishment of a central agency to act as a clearing house.

04.8 Safeguarding Retirement Income from Second Pillar Pensions

The economic and financial turmoil has demonstrated that the application of the 'prudent person' principle, particularly within the Anglo-Saxon market, failed to provide the necessary protection. Financial institutions, it has been clearly shown, have directed their investment decisions towards short term quick returns spurred by a culture of bonuses, as against making prudent decisions that protect the assets of their members and allow for growth over the long term. The end result has been a quasi total nationalisation of a considerable number of the largest western financial institutions.

As discussed earlier, the WG does not believe that it should restrict the type of pension schemes that an organisation should opt for. The WG believes that a decision to adopt a DB scheme should not be taken lightly and that both the employer and the representative Union should be conscious of the implications such a scheme may have. Developments seem to indicate that DB schemes will die a natural death – only recently, for example, Barclays have announced that it is converting its DB scheme into a hybrid DC scheme.

Thus, the WG anticipates that the absolute majority of schemes that will be set up in Malta will be DC schemes. In a DC scheme the risk of the accumulated capital until the person retires rests directly with the person: in that if market forces, as has happened recently, turn negative the loss in accumulated capital will directly affect the value of pension income.

The challenge with a DC scheme is the balance that should be reached between investing in high return equity which will lead to a larger accumulated capital but carry a high risk, and investing in bonds which will result in a smaller accumulated capital but are far less risky.

The WG is recognizant of the fact that the MFSA is developing a new Pensions Act that is principally based at establishing the regulatory framework for private pension provision in Malta and at establishing a new international pension service market. The Pensions Act, as currently being designed, is based on

[50] Pg 3, Ibid

the conclusion that the prudent man principle should be supported by a number of investment restrictions in relation to Second Pensions – restrictions that are primarily related to:

(a) not more than 5% of the Scheme's assets are to be invested in contributor related investments

(b) not more of 30% of a Scheme's assets are to be invested in assets (shares, debts securities, moveable and immovable assets) which are not traded in or dealt on a market which is regulated, operates regularly, is recognised and is open to the public and has adequate liability and adequate arrangements in respect of the transmission of income and capital – with the mix of 30% to be determined subject to the following:

  (i) investments in such assets should always be carried out on an arms' length.

  (ii) the Scheme's assets may be directly or indirectly invested in commercial or residential Immovable Property subject that:

    - Direct investments in *commercial or residential immoveable property* are effected as follows*:*

      - not more than 10% of a scheme's assets shall be invested in a single property;

      - before a property is acquired, it must be valued by an <u>independent qualified valuer(s)</u>

      - the property must be acquired within 6 months from the date of the report and at a price which is within 5% of the valuation price;

      - not more than 5% of a scheme's assets should be invested in residential property;

      - any *residential property* acquired by the scheme is not for the direct or indirect use of members or contributors or beneficiaries

    - Indirect investments in *commercial or residential immoveable property* are effected as follows*:*

      - may be effected through the purchase of <u>property related assets</u> which are defined as securities (bonds or shares or similar instruments) issued by <u>property management companies</u> and/or <u>property financing companies</u> and/or property development companies and/or other companies, including collective investment schemes, whose main objective is to own or invest in immoveable property]

      - not more than 10% of a scheme's assets shall be invested in a single issuer or a single issue of property related assets

      - in the case of investment in bonds issued by property management or financing companies or property owning companies, reasonable steps shall be taken to ensure to the extent possible, that the issuer has made sufficient provision for the repayment of the bond at maturity;

    - The Scheme's percentage (direct or indirect) investment in immoveable property is subject to six monthly reporting to the MFSA to ensure that the immoveable property exposure limit is satisfied on an on-going basis.

(iii) any investments in unlisted alternative assets (e.g. hedge funds) shall be permitted, subject that not more than 10% of a scheme's assets is invested in any single asset of this type.

(iv) investments in tangible moveable assets (e.g. classic cars, fine wines, art, yachts, antiques, etc) are permissible subject to the following:

- Indirect investment is permitted through investment vehicles, whose objective must be to invest or own these type of tangible movable assets and which hold a genuinely diversified portfolio of such assets and which vehicles must be traded in or dealt on a market which is regulated, operates regularly, is recognised and is open to the public or has adequate liquidity and adequate arrangements in respect of the transmission of income and capital or is provided for in the scheme document.

- Direct investment should be effected subject to the following requirements*:*

    - not more than 10% of a scheme's assets shall be invested in a single moveable asset;

    - before a moveable asset is acquired, it must be valued by an independent qualified valuer(s) approved by the MFSA

    - the moveable asset must be acquired within 6 months from the date of the report and at a price which is within 5% of the valuation price;

    - any moveable asset acquired by the scheme is not for the direct or indirect use of members or contributors or beneficiaries (for example: the moveable asset may not be leased back or rented out to a member or a member's employer or beneficiary, or constitute an asset purchased for the member's or a beneficiary's own use or used as by members or beneficiaries etc.. examples provided should not be considered as exhaustive).

- The Scheme's percentage (direct or indirect) investment in tangible moveable property is subject to six monthly reporting to the MFSA to ensure that the moveable asset exposure limit is satisfied on an on-going basis.

(c) The assets of the Scheme shall be invested in derivative instruments only insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution's assets. Excessive risk exposure to a single counterparty and to other derivative operations shall be avoided. The Scheme shall not be leveraged or geared in any way through the use of futures, options or other derivatives;

(d) In particular, the Scheme assets shall be invested as follows:

(i) not more than 10% of assets shall be invested in securities issued by the same body;

(ii) not more than 10% of the assets shall be kept on deposit with any one body. This limit may be increased to 30% in respect of money deposited with a credit institution licensed in Malta or in any other EEA State, or with any other credit institution which has been approved by the MFSA;

(iii) the Scheme shall not hold more than 10% of any class of security issued by any single issuer.

Provided that, subject to approval from the MFSA, the above limits may not apply to investment in government bonds.

(e) subject to the provisions of the Scheme Document, the Scheme may borrow as long as the borrowings do not exceed 10% of the value of the Scheme and provided such borrowing is temporary and for liquidity purposes;

(f) a Scheme shall not grant loans or act as guarantor on behalf of a third party. This is without prejudice to the right of the Scheme to acquire debt securities;

(g) the Scheme may invest up to 100% of its assets in a Retirement Fund licensed under the Act or an equivalent arrangement overseas or in a single insurance policy. In the case where the Retirement Fund is managed or advised by the same Investment Manager or Advisor or by an associate of the Scheme's Investment Manager or Advisor, arrangements shall be made to eliminate more than one set of charges on acquisition or disposal and more than one set of management and/or advisory charges;

(h) the Scheme may acquire the units of Collective Investment Schemes adequately regulated subject to the following:

  (i) where a Scheme invests in the units of a collective investment scheme managed or advised by the same Investment Manager or Advisor or by an associate of the Scheme's Investment Manager or Advisor, arrangements shall be made to eliminate more than one set of charges on acquisition or disposal and more than one set of management and/or advisory charges;

  (ii) where commission is received by the Investment Manager of the Scheme by virtue of an investment in the units of a collective investment scheme, that commission shall be paid into the property of the Scheme;

  (iii) any underlying collective investment scheme must be properly diversified and predominantly invested in regulated markets (except for collective investment schemes investing in immovable property);

  (iv) the Scheme shall not invest in a feeder fund or, without MFSA approval, in a fund of funds;

  (v) not more than 20% of the Scheme's assets shall be invested in total in any one collective investment scheme which is properly diversified and predominantly invested in regulated markets. However, where the Scheme is set up as a Fund of Funds, it may invest up to 30% of its assets in any one underlying collective investment scheme which is adequately regulated.

(i) the Scheme and its Investment Manager, taking into account all of the Schemes and other collective investment schemes which the latter manages, shall not acquire sufficient instruments to give it the right to exercise control over 20% or more of the share capital or votes of a company, or sufficient instruments to enable it to exercise significant influence over the management of the issuer.

It is to be noted that these qualitative investment restrictions are designed within the parameters set by the EU Pensions Directive – particularly Article 18 titled 'Investment Rules'.

Recommendation 36

The Working Group supports the introduction of the investment restrictions rules as a check on the discretionary authority stemming from the 'prudent person principle' in the revised Special Funds Act; and adds that the latitude provided by the EU Pensions Directive in terms of such restriction should be maximised to the utmost possible.

Nevertheless, the WG is of the considered opinion that, in the wake of the lessons arising from the financial turmoil, such investment restriction rules do not go far enough to limit the misuse or abuse of the management of pension funds to generate short-term gain to the financial institution as against that of protecting the contributors over the long term.

There is today considerable discussion and recognition in the USA, UK as well as in continental Europe on the need to radically overhaul the financial services regulatory regime. The WG believes that such discussion will also take place within the EU Commission which will seek to tighten the EU regulatory framework to avoid a repetition of the recently experienced financial and economic collapse.

The WG states that Malta's position should be directed toward the strengthening of quantitative investment criteria and the reduction of the discretionary authority acquired under the 'prudent person principle' with particular regards to Second Pillar Pensions including OPR Schemes.

The WG argues that such a position should be taken for the following reasons:

01. A saving for retirement is, most likely, one of the fundamental decisions that a person takes in his or her life time. Such a decision will affect, positively or negatively, his or her quality of life during retirement which can easily be 20 years away and thus the possibilities that capital that he or she is accumulating for his or her retirement can be 'gambled' by pension service providers for short time gains as against the protection of his or her long term interests must be minimised.

02. The introduction of a Second Pillar Pension framework will take place in a period where the market will be immature and where mistakes will be made, lessons will be learnt until such time that the market stabilises and matures. It is thus believed to be of critical importance that during this period contributors to a Second Pillar Pension are not exposed to unnecessary risk.

03. The Second Pillar Pension will be introduced in the aftermath of the most sever economic and financial crisis since the Great Depression. The on-going daily media coverage on the behaviour of financial institutions, the consequences on jobs as a result of such behaviour et al, undoubtedly, will leave a psychological imprint on most people. It is reasonable to assume that such an imprint will result in considerable hesitation before people start trusting financial institutions with their hard earned money. If a voluntary Second Pension is to work it is believed to be of critical importance that people are assured that their money will not be 'gambled' by some fund manager to earn a hefty bonus by *ex-ante* mechanisms that restrict and disallow such behaviour at the first instance.

Recommendation 37

The Working Group recommends that the Government, in discussions that will be undertaken at EU Institutional level on the financial services and pension regulatory framework as a direct result of the 2008 / 2009 economic and financial crisis, should strive to seek a strengthening of qualitative investment criteria and a diminished discretionary authority under the 'prudent person principle' in relation to Second Pillar Pensions including Occupational Retirement Pensions.

Research indicates that, in more financially sophisticated markets, such as the case of the UK, people do not make informed choices or do not analytically shop around when they come to purchase a financial product.[51] In fact, surveys report that people feel overwhelmed and confused by the amount of information and the complexity of choices.

Moreover, research also shows that the complexity of the charge structure means that, in general, charges are poorly understood by the average pension fund member. For example, a survey in Poland showed that 63% of contributors declared very limited understanding about contribution fees, and 71% declared limited understanding about management fees. More than 40% of those surveyed did not know that there was a transfer fee for moving one's account to another provider.[52]

In 1998, Sweden introduced a second tier of mandatory individual accounts — the Premium Pension — in the public system.[53] The Premium Pension provides choice between 650 funds and at their introduction 70% of the individuals played an active investment position. By 2004, only 10% made active choices with respect to their portfolio. It is to be noted that the rest gravitated towards a default fund option.

In essence, therefore, the provision of a default fund option would ensure that persons seeking to invest in savings for their retirement are directed towards a well designed pension fund that establishes an appropriate balance in terms of charges, investment exposure, et al. The experience of Sweden, shown above, shows the success of a well designed default funds.

The New Zealand Herald of 16th September 2009 reported that KiwiSavers who invested their pension savings into default schemes were the least affected by the global credit markets – where 4 of the 5 default funds surveyed posting positive returns.[54]

Thus, whilst pension providers should have the necessary latitude to design pension schemes as they deem appropriate, the WG argues that the Government should introduce default schemes for all of the schemes proposed in the VSP framework that balance high long term rates of returns with the desired risk profile of investors.

Recommendation 38

The Working Group recommends that whilst pension providers should have the necessary latitude to design pension schemes as they deem appropriate, Government should introduce default schemes for all of the schemes proposed in the Voluntary Second Pillar Pension framework that balance high long term rates of returns with the desired risk profile of investors.

[51] Department of Work and Pensions, UK, "Security in Retirement: Towards a New Pension System", pg.56 (White Paper published in May 2006)
[52] Pg 3, Tapia, W., and Yermo, J., Fees in Individual Account Pensions Systems: A Cross-Country Comparison, OECD Working Papers on Insurance and Private Pensions, No 27, OECD Publishing, September 2008
[53] The Swedish Authorities established a new government pension agency, the PPM (Premiepensionsmyndigheten), to administer the plan and act as a clearinghouse. The clearinghouse model was chosen to keep administrative costs down by drawing on economies of scale in administration.
[54] http://www.nzherald.co.nz/kiwisaver/news/article.cfm?c_id=1501206&objectid=10537491

Appendix 01: Impact of the Crisis on Private Funds

01. Selected European Countries[55]

Ireland: Ireland is one of the few countries with a strong reliance on private funded pensions for those retiring today. Most of the defined benefit funds are currently in a deficit and most of the defined contribution funds realise a negative return on assets. The average fund return in the 12 months to the end of January was substantially reduced.

The Netherlands: Dutch defined benefit pension funds guarantee security to members by a funding buffer with funds normally targeting assets to be 130% of liabilities. If the funding ratio between assets and nominal, that is non indexed, liabilities ratio fall below 130%, measures are to be taken to restore the funding position within 15 years and for funds below 105%, they must have a plan to reach 105% within 3 years, before reaching 130%. The 3 year time span has recently been temporarily extended to 5 years. The ratio (or capitalisation rate) of pension funds in has declined from 140% of nominal pension rights at the end of 2007 to a February 2009 value of around 90%.

Denmark: In Denmark, value of assets in the private funds has decreased from around 138 percent of GDP in 2007 to an estimated 119 percent of GDP in 2008.

Sweden: The most important element of the Swedish pension system is pensions from the Notional Defined Contribution (NDC) scheme, backed by a reserve fund (the AP funds). If the NDC pension system is in deficit, a so-called automatic balancing mechanism is triggered, leading to a lowering of the indexation of the pensions until a positive financial balance is restored. The value of the assets in the PPM system, the mandatory funded part of the Swedish pension system, has dropped by 34.5% between end-2007 to end-2008. As the system is introduced newly the effects on paid out pensions is very limited.

United Kingdom: The UK has a long history of private pension provision. Over the past year weaker equities reduced asset values by 14.5%, whilst lower bond yields resulted in a 6.5% increase in aggregate liabilities. Consequently, approximately 90% of existing Funds are in deficit.

02. Private Pension Funds in the UK

The National Association of Pension Funds (NAPF) of the UK conducted a survey among member pension schemes in order to assess the likely impact of the recession on pension provision.[56] The questionnaire was distributed in January 2009 and repeats questions asked as part of the NAPF Annual Survey conducted in July 2008 before the sharp downturn in the FTSE stock market index. A total of 100 schemes responded, with assets totalling £180.5 billion and just over 3 million members.

Annual Survey results showed relative stability in pension provision, with 28% of defined benefit (DB) schemes open to new members and large numbers of respondents predicting no change to their pension scheme. The relatively optimistic picture which emerged from the Annual Survey 2008 has changed significantly in the wake of the current economic downturn. In addition employees were also asked for their comments in order to provide a complete picture.

It is evident from the replies of employers' that in the case of new employees in open private sector DB schemes, a general shift in preference towards DC schemes was noted. According to the NAPF over 1,000 DB schemes could face closure to new entrants over the next five years. A similar response was

[55] Reproduced from "The 2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States 2008-2060", Brussels, April 2009

[56] http://www.napf.co.uk/DocumentArchive/Policy/Reports%20and%20Responses%20to%20Consultations/08_2009/20090123_Pension%20provision%20and%20the%20economic%20crisis%20-%20Jan%202009.pdf

noted for existing members of open private sector DB schemes, with a significant reduction in respondents claiming that no change will be made. The difference emerging was that while employees already in the scheme will tend to maintain the provision of a DB pension, new employees will tend to be shifted to a DC scheme. Indeed, DB provision will be mainly maintained for existing members in schemes having membership of 1 million people and an asset value of £72 billion. Schemes planning to switch to some form of DC provision have a membership of over 800,000 and assets of £7.9 billion.

There was also a similar shift in expectations of changes to private sector DB schemes which are closed to new members but open to future accrual, although DB scheme format will tend to be maintained. Indeed, there are 377,000 people in such closed schemes with total assets of over £63 billion. Other schemes are more willing to switch their 197,000 members to DC scheme pensions, managing assets of over £15 billion.

Generally speaking, most schemes believe that DB pension provision will be severely affected. Around 72% of the respondents believe that the economic crisis will make the closure of DB schemes currently open to new employees much more likely, with just 2% believing that there would be no impact. Respondents also believe that the crisis will have a significant effect on members of closed schemes, with 95% believing that closure of schemes to future accrual being more likely, and only 2% believing that there would be no impact.

Respondents were asked if they thought the crisis would bring about any changes to the design of DC pensions; where 73% felt that that there will be additional member communications; 47% said that lifestyle funds will be redesigned to ensure people are protected from very severe falls at key switching points; and 46% thought that default funds would be redesigned so as to reduce volatility and increase protection from sudden drops in the stock market. Only 14% said that there would be no impact on DC pension design.

Respondents were also asked to suggest potential steps which the Government and/or The Pensions Regulator (TPR) should take to help pension schemes in this economic period. 67% of respondents would like to see the Government issuing more long-dated gilts for auction. 46% thought that legislation could be introduced which would help schemes to reduce liabilities, such as by making it easier for schemes to increase the normal retirement age. 35% felt that TPR should allow 15 years instead of 10 years for schemes to achieve their Statutory Funding Objective. Other suggestions included making it easier to introduce risk-sharing arrangements as alternatives to pure DB or DC, and the Government making it explicit that it is the guarantor of last resort for the Pension Protection Fund (PPF).

The NAPF surveyed also the employee's perspective in order to assess the confidence of scheme members and non-members in workplace pensions as a form of retirement saving compared to other savings options. Over 1,100 working people are covered by the survey.

In particular, it is noted that confidence in workplace pensions versus other forms of saving for retirement improved markedly from February to September 2008, rising from +3% to +22%, at the height of the stock market turmoil. However, this was reversed after the turmoil in the fourth quarter of 2008, as the index for all employees fell to +1% in December 2008. NAPF research has shown that the most frequently cited reason for people not joining a pension scheme when one is available is affordability.

Pensions have consistently topped consumers' preferences as the best way to save for retirement; however the last year has seen a decline in favourability. Encouragingly, employees are fairly resilient in their pension saving despite the economic turmoil, as 82% of respondents said they do not intend to make any changes to their current pension arrangements.

03. Impact on Developing Countries

This section draws on the World Bank report 'The Financial Crisis and Mandatory Pension Systems in Developing Countries' published in the World Bank published in 2008.[57]

According to the Report, the impact of the financial crisis on individuals participating in funded defined-contribution schemes depends on four main factors:

- Changes in asset prices and the potential recovery over the medium term.
- The proportion of pension wealth that is supported by funded individual account assets.
- The presence of minimum social pensions or guarantees that are integrated into the pension system.
- The requirement and framework for mandatory annuitisation of the accumulated balance at retirement.

Losses reported in World Bank client countries with funded systems over the last 12 months were considerable, ranging from 8% to 50%. However, the 13 mandatory pension funds for which data was available, still managed an average annual real rate of return of 6% over the period 1994 to 2007. Uruguay, Peru and Poland were the top three performers with average annual real rates of return in excess of 9%. Argentina, Croatia and the Czech Republic were the worst performers with average annual real rates of return below 4%.

Real Returns of Mandatory Pension Funds (year-on-year)				
		Growth	Balanced	Conservative
Chile	13-Oct	-46.1	-23.1	0.0
Mexico	30-Sep	-8.3	-6.0	-0.5
Peru	10-Oct	-47.8	-33.9	-14.5
Uruguay	30-Sep		-7.5	
Croatia	30-Oct		-14.1	
Estonia	15-Oct	-30.5	-20.9	-9.7
Hungary	15-Oct	-35.0		-18.0
Lithuania	15-Oct	-48.4	-32.6	-9.4
Poland	30-Sep		-17.4	
Slovak Republic	13-Oct	-12.4	-10.3	-2.0

The report observed that most countries with mandatory funded pensions have multi-pillar systems in which funded individual accounts form only part of the overall retirement package. Retirement-income systems that relied to a greater extent on defined contribution schemes are more exposed to the financial crisis. These include those of Chile, El Salvador, Mexico and Peru. However, the impact of the declines in asset values in Mexico will be compensated for persons who retire before asset values recover. The pension systems in these four countries consist of mandatory defined contribution schemes for more than 82% of total retirement packages.

Furthermore, the World Bank noted that many countries also provide social pensions or offer minimum pension guarantees. The average value of these benefits varies across countries, with an average of 30% of the average economy-wide earnings. As a result, even when pensions are heavily exposed to fluctuations in the value of financial assets, minimum pension guarantees shield lower-income workers from poverty in the majority of cases. Iran, Colombia and Portugal possess the highest minimum pension guarantees, which are in excess of 40% of the average economy-wide earnings. Bulgaria, Morocco and Estonia offer the lowest minimum pension guarantees, which amount to less than 20% of the average economy-wide earnings.
It was also noted that only a small number of workers will retire during the period in which their pensions would be reduced due to the decline in asset values. Some funded systems have established multiple

[57] http://siteresources.worldbank.org/INTPENSIONS/Resources/395443-1121194657824/PRPNote-Financial_Crisis_12-10-2008.pdf

portfolios that include conservative options that are primarily invested in short term government debt. Although these portfolios provide a relatively lower rate of return, they shield plan members from most of the losses in asset values.

04. Other Observations

As noted by the European Commission in the Communication 'The economic crisis and pensions in the EU' of the 6 of March 2009, pensions are not immune from the financial crisis, however the long term nature of pensions gives some natural protection.[58] The particular impact depends on the nature of the pension scheme.

In the case of Pay-as-you-go (PAYG) statutory pension schemes, these tend to be affected to a lesser extent as the economic downturn reduces their stream of revenue and potentially increases benefit claims. In addition, the larger national debt may increase the need for policy adjustments, but these can be phased in over the longer term.

Meanwhile in the case of DB occupational pension schemes, there exists a series threat to these pensions in the future, as noted in the case of the UK above. Some DB schemes have turned to a deficit due to falls in investments and will seek to restore their funding balance. This poses impacts on individuals which include; adjustments to indexation and/or contributions, acceleration in the long term trend for DB schemes to close to new members or even accruals to control costs.

There are significant threats to investors in DC pension schemes as they can expect lower benefits if they decide to retire at present, due to the financial crisis. However, DC schemes tend not to be a large element of overall retirement income for most people today. At the same time, DC pensions are expected to play a bigger role in future overall pension income.

The impact of the crisis changes according to MS. While it is too early to predict precise impacts, it is clear that all MS pension systems will be affected given the severity of the financial crisis. However, the impact varies by individual pension fund according to the particular scheme type, investment strategy and horizon, among many other characteristics.

At the same it is noted that Funded DB pension schemes have a number of features that make them more resilient to current market events than some other financial institutions, including banks. These include mainly long term liabilities, long term approach to investment, no evidence pointing towards significant pension fund investments in toxic assets and no significant gearing.

As a result, a pension fund's liabilities falling due today are a small proportion of their total assets and they still have income from both active member contributions and investment income to help liquidity and solvency. Pension funds still need to take action in the short term to safeguard their long term health and national supervisory bodies together with the EU have a role to play.

According to the EC, DC pension schemes need to ensure that investment frameworks are designed to encourage the right choices and that the lifecycling or lifestyling of asset allocation is the mainstream option for everyone. MS should also give careful consideration to the appropriate maximum proportion of overall pension income expected to come from DC pensions, particularly for the less well off who may be less able to absorb the inherent risks. Underlying structural issues regarding the sustainability of pension systems have been exposed by the financial crisis, as overoptimistic expectations of returns made in earlier good times helped to dispel such fears without proper analysis.

In the case of Developing Countries, the World Bank noted that the maturity of the scheme is crucial in determining the extent of the financial impact. Countries which will face the greatest fiscal pressures are those where financial flows from contributions and investments are less than current expenditures and

[58] http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/99

those where liquid reserves could face the greatest fiscal pressures. Some countries in this situation include: Azerbaijan, Brazil, Egypt, Morocco, Russia, Serbia and Tunisia.

In addition the effects on members depend on government procedures of dealing with the shortfall in revenues. The main difficulties will be observed in countries that have overall fiscal deficits and rely on external debt financing that has become increasingly difficult to refinance with the global credit crunch.

The World Bank also noted that countries that have introduced funded second pillars may be tempted to re-allocate the portion of the social insurance contributions that previously went to PAYG schemes back to the public schemes. This may imply that short-term cash flow issues might be addressed at the expense of risking negative long-term consequences on the individual benefit position.

Appendix 02: Short Review of Private Pension Instruments

Malta has no voluntary Second Pillar and Third Pillar pensions market. This Chapter seeks to provide an overview of the main pension fund instruments that may be approved for regulation by the Malta Financial Services Authority (MFSA).

01. Defined Benefit Scheme

Defined Benefit Schemes are pensions instruments where the benefits, which are ordinarily determined by the scheme rules, are defined in advance. Benefits are often related to the final salary and/or years of service of the employee. Typically the benefit is provided in the form of an income for life; though some schemes may offer a lump sum in addition to the pension or members may have the option to exchange part of their income for life for a cash lump sum. The main decision which members need to make at retirement is whether to surrender pension for a cash lump sum – if this is an option – or retain the full level of pension.

The fact that benefits are defined in advance provides certainty to the individual for retirement planning, and the defined benefit is easily assessed from an adequacy point of view. Contributions are generally made by the employer and often also by the employees. Contributions are normally determined by a number of factors, such as:

- scheme assets at any time.
- the composition of scheme membership.
- the changing salary levels of scheme members.
- changing mortality rates and their impact on the costs of providing benefits.
- the investment returns on scheme assets.
- changing regulatory requirements.

The delivery of the quoted benefits is the main responsibility of the employer (who is generally the guarantor of the defined benefits). Thus, the investment risk of this type of scheme is carried by the employer who is obliged to make good, at the time of pay-out, any shortfall between the investment returns achieved by assets and the quoted benefits. This means that employers may be exposed to increasing costs to ensure that such a scheme will be in a position to meet its liabilities.

Any increase of costs for the maintenance of such a scheme may also affect the solvency of the employer. The fact that costs associated with these type of schemes may rise or fall throughout the life of the scheme give rise to issues of sustainability.

The main risk for beneficiaries is the solvency of the employer so as to be in a position to meet the promised benefits. Given the fact that generally the benefits receivable under these type of schemes are based on final salary, these schemes are generally designed namely for long-serving employees. Any early opt-outs from Defined Benefits Schemes generally entails loss of benefits due to the fact that in Defined Benefits Schemes the assets are owned by the guarantor of the fixed benefits which are usually calculated on final salary[5]. This hinders mobility of employees.

It is pertinent to underline, that a over the past years a number of 'blue chip' companies have found themselves in difficulties given that their Defined Benefits Pensions Funds face substantially large short falls – with firms increasingly ring fencing existing Defined Benefits schemes and offering new members Defined Contribution schemes.

02. Defined Contribution Scheme

Defined Contribution Schemes are pension instruments where the retirement benefit is not known or defined in advance. Whilst part of the fund of a Defined Contribution scheme may be taken tax-free the major part of the balance is converted into an annuity; where level of retirement income receivable on pay-out date is related to the:

- level of contributions made over the accumulation period;
- the charges deducted by the product provider;
- the investment returns of the fund during the accumulation phase;
- the annuity rates at retirement.

The beneficiaries carry the risk of fluctuating pension levels and also face the uncertainty about the level of pension benefit receivable from the scheme. This makes it more difficult for purposes of planning for retirement and also to measure the adequacy of the benefits receivable, unless members have access to regular and focused feedback about the scheme's performance and the benefit due to them.

Contributions are generally made by the employer and the employee and these are fixed in advance – so the cost of a Defined Contribution scheme is known in advance. This should not give rise to issues of sustainability, as in theory these type of schemes cannot be in deficit.

Defined Contribution scheme are transparent and more flexible in terms of calculating the amount of pension due to an individual at any point in time. This is due to the fact that proportional assets are directly attributable on an individual basis, and hence the value is more easily and accurately calculated. This makes a Defined Contribution scheme portable and attractive for part-time workers and a mobile work-force.

03. Hybrid Schemes

The Defined Benefit scheme and the Defined Contributions scheme compromise two opposite poles in terms of pension instruments. Alternatives exist in terms of schemes where employers may tailor the features of Defined Benefit Schemes offering benefits at a lower scale to reduce the associated investment and costs risks by:

- increasing retirement ages;
- increasing contributions by members;
- limiting personable salary increases.

It is pertinent to note that this will only partially address the issue of costs given that in so far that an element of a 'defined' benefit within the instrument then the risk of sustainability – albeit with a lower degree of exposure – remains for the employer.

Some markets, particularly the US, have seen the emergence of Occupation Retirement Pensions Schemes titled as Hybrid Schemes – which seek to combine features of Defined Benefits and Defined Contribution schemes respectively in some way and can take a variety of forms. For example:

- A Defined Contribution scheme with the option for employees who have been with the company for a certain number of years to move into a Defined Benefits scheme.
- A Scheme promising pensions based on average career earnings rather than final salary, or which changes the amount of pension one can expect for each year of service completed.
- A Defined Contribution scheme offering a guarantee that it would not fall below the level that would be provided by a Defined Benefits scheme. The guarantee offers some protection against the pension scheme's investments performing badly.
- A Self-Annuitising Defined Contribution scheme which operates identically as a Defined Contribution scheme until the member retires – from which point the accumulated fund is converted to pension income not at the market rate for pension costs but in accordance with the rules set out in the scheme.
- A Final Salary Lump Sum scheme where the retirement benefit is expressed as a lump sum at retirement rather than as a pension. The contribution rates for these schemes will be more stable than a typical Defined Benefit scheme given that the longevity risk is removed from the scheme.

Hybrid Schemes can combine the best, or the worst, of both DB and DC schemes. They can be relatively complex and potentially involve higher administration costs as well as necessitate certain employee educational and communication efforts.

Hybrid Schemes can, however, potentially offer a significant opportunity of offering some level of retirement-income guarantee, without incurring the full cost and risk of traditional DB arrangements. In fact, the main common and most important feature of Hybrid Schemes is that they spread the risk of pension provisioning between the employer and the employee and allow for greater flexibility. Employers do devolve a degree of the investment risk to employees but often guarantee an investment return to workers such that the expected return on Scheme's assets is sufficient to cover the cost of these risks. Workers do retain some residual investment risk depending on the form of the Hybrid Scheme – for example in so far as returns over the minimum guaranteed amount or early in the life of the Scheme. However workers often have a certain degree of certainty in so far as part of their retirement income, which is guaranteed, is concerned.

Also, Hybrid Schemes tend to be more age neutral in their retirement incentives than traditional Defined Benefits plans and most Hybrid Schemes do not have early retirement incentives.

04. Annuity with Guaranteed Rates[59]

Guaranteed income, either level or with fixed increases or full or partial inflation linkage.

05. With-Profit Annuities[60]

With-profit annuities provide a low level of guaranteed income. Annual revisionary bonuses are declared annually to augment basic income. Once granted a bonus income becomes guaranteed for the rest of the policy. Different variants exist.

06. Unit-Linked Annuities[61]

Unit-Linked Annuities offer the prospect of higher income the discretion of the insurer. The level of income is linked to the price of units in some unit-linked funds managed by the insurer. There is generally a choice of unit fund and ability to switch from one to another. This avoids being tied to initial gilt yields but may lead to volatile income payments.

07. Phased Drawdown Plan[62]

Phased Drawdown Plans involve segmenting the personal pension pot into many small policies. Benefits which will include lump sum and annuity may be drawn from each segment independently of the others, rather than taking the initial lump sum and a single annuity. The segments may be left untouched up to a pre-determined age (75 years in the United Kingdom) or used earlier to increase income.

08. Income Drawdown Plan[63]

Variants exist. For example an Income Drawdown Plan may be constituted in a manner that allows for an immediate tax-free cash sum of say up to 25% of the fund; an income drawn from the remaining fund; continued control of the investment within the fund; and the purchase of an annuity at a pre-determined age level. On death of the member during the deferred period the beneficiary will have the ability to take the remaining fund as a lump sum but subject to tax.

An Income Down Plan has a mortality drag: in a conventional annuity the amount of the income received by an annuitant who remains alive contains an element of cross subsidy from those who bought annuities but have passed away. A policyholder in good health who elects instead for income withdrawal will not receive this subsidy but instead retains a substantial death benefit.

[59] Pg 152, Benefit Options at Retirement, Hewitt Associates, Ireland, May 2005
[60] Ibid
[61] Ibid
[62] Ibid
[63] Ibid

Appendix 03: Article 18 of the EU Pensions Directive

Article 18 of the EU Pensions Directive applies solely to second pillar private occupational pension schemes.

Article 18
Investment rules

1. Member States shall require institutions located in their territories to invest in accordance with the 'prudent person' rule and in particular in accordance with the following rules:

   (a) the assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;

   (b) the assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits;

   (c) the assets shall be predominantly invested on regulated markets. Investment in assets which are not admitted to trading on a regulated financial market must in any event be kept to prudent levels;

   (d) investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution's assets. The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations;

   (e) the assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the institution to excessive risk concentration;

   (f) investment in the sponsoring undertaking shall be no more than 5 % of the portfolio as a whole and, when the sponsoring undertaking belongs to a group, investment in the undertakings belonging to the same group as the sponsoring undertaking shall not be more than 10 % of the portfolio.

   When the institution is sponsored by a number of undertakings, investment in these sponsoring undertakings shall be made prudently, taking into account the need for proper diversification. Member States may decide not to apply the requirements referred to in points (e) and (f) to investment in government bonds.

2. The home Member State shall prohibit the institution from borrowing or acting as a guarantor on behalf of third parties. However, Member States may authorise institutions to carry out some borrowing only for liquidity purposes and on a temporary basis.

3. Member States shall not require institutions located in their territory to invest in particular categories of assets.

4. Without prejudice to Article 12, Member States shall not subject the investment decisions of an institution located in their territory or its investment manager to any kind of prior approval or systematic notification requirements.

5. In accordance with the provisions of paragraphs 1 to 4, Member States may, for the institutions located in their territories, lay down more detailed rules, including quantitative rules, ***provided they are***

prudentially justified, to reflect the total range of pension schemes operated by these institutions. In particular, Member States may apply investment provisions similar to those of Directive 2002/83/EC.

However, Member States shall not prevent institutions from:

(a) investing up to 70 % of the assets covering the technical provisions or of the whole portfolio for schemes in which the members bear the investment risks in shares, negotiable securities treated as shares and corporate bonds admitted to trading on regulated markets and deciding on the relative weight of these securities in their investment portfolio.

Provided it is prudentially justified, Member States may, however, apply a lower limit to institutions which provide retirement products with a long-term interest rate guarantee, bear the investment risk and themselves provide for the guarantee;

(b) investing up to 30 % of the assets covering technical provisions in assets denominated in currencies other than those in which the liabilities are expressed;

(c) investing in risk capital markets.

6. Paragraph 5 shall not preclude the right for Member States to require the application to institutions located in their territory of more stringent investment rules also on an individual basis provided they are prudentially justified, in particular in the light of the liabilities entered into by the institution.

7. In the event of cross-border activity as referred in Article 20, the competent authorities of each host Member State may require that the rules set out in the second subparagraph apply to the institution in the home Member State. In such case, these rules shall apply only to the part of the assets of the institution that corresponds to the activities carried out in the particular host Member State. Furthermore, they shall only be applied if the same or stricter rules also apply to institutions located in the host Member State.

The rules referred to in the first subparagraph are as follows:

(a) the institution shall not invest more than 30 % of these assets in shares, other securities treated as shares and debt securities which are not admitted to trading on a regulated market, or the institution shall invest at least 70 % of these assets in shares, other securities treated as shares, and debt securities which are admitted to trading on a regulated market;

(b) the institution shall invest no more than 5 % of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital-market instruments issued by the same undertaking and no more than 10 % of these assets in shares and other securities treated as shares, bonds, debt securities and other money and capital market instruments issued by undertakings belonging to a single group;

(c) the institution shall not invest more than 30 % of these assets in assets denominated in currencies other than those in which the liabilities are expressed.

To comply with these requirements, the home Member State may require ring-fencing of the assets.

Appendix 04: Revising the Special Funds (Regulation) Act

01. Introduction / Background

The Special Funds (Regulation) Act ("SFA") came into effect on 1st October 2002. It provides the legal framework for the establishment and regulation of retirement schemes, retirement funds and their related service-providers. The SFA caters primarily for the establishment of occupational retirement schemes, although it also addresses third pillar schemes, since a retirement scheme may be tailored for use outside an employment relationship.

The SFA, when enacted, was primarily intended towards the international pensions market. In the meantime, the EU Pensions Directive (Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision) – which came into effect in September 2005 – has been fully transposed into Maltese law through this Act[64]. Moreover, in its final report to the Government dated June 2005, the Pensions Working Group chaired by Mr David Spiteri Gingell, had recommended that the SFA should be used as the legal framework for the regulation of occupational and private retirement schemes should the Maltese pension system be reformed into a three pillar pension system.

Developments arising following the transposition of the EU Pensions Directive, other developments in the field of international pensions during the past six years as well as comments raised by the industry in previous consultations have prompted the need to review the SFA. The aim is to develop the SFA framework to make it competitive and attractive for operators, especially in view of the passporting opportunities for pension schemes following the transposition of the EU Pensions Directive, while at the same time maintaining high regulatory standards. **It should immediately be clarified that this review of the SFA does not in any way affect the Maltese pension system nor is connected with any planned reform thereof.**

02. Proposal

The extent of the proposed revisions suggests the drafting of new legislation which would replace the current SFA. General information regarding the proposed Bill and the main proposed changes vis a vis the current SFA are explained below:

- *Change in Name:* The Bill proposes the new law to be renamed Retirement Pensions Act. The new name gives a clearer indication that the proposed act relates to pensions.

- *Objective:* The Bill still provides (similar to the SFA) a regulatory framework for the regulation of retirement schemes, retirement funds and service providers related thereto. However to note in this regard that:
  - The Bill makes it clearer that *Retirement Schemes* may be 'occupational' as well as 'personal' schemes;
  - *Retirement Funds* have been retained as pension pooling vehicles. In terms of the EU Pensions Directive, it was no longer possible to require retirement schemes to invest solely through one or more retirement funds as initially required under the SFA;
  - The list of *Service-Providers* has been revised and now includes Retirement Scheme Administrators, Retirement Scheme / Fund Asset Manager, Retirement Scheme / Fund Custodian/Trustee, Back-Office Administrators. Further details in this regard are provided below.

[64] Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision stipulates certain minimum requirements for the regulation of occupational pension schemes and provides for the passporting of such entities across the EU and EEA States. Countries which do not have any occupational pension schemes within their national pension framework were still required to transpose this Directive for purposes of the single market in financial services. The transposition of this Directive does not affect the national pension structure of the Member States.

- *Structure of the law* – The Bill provides a regulatory framework which is principle based. The intention is to make the new law more user-friendly and less prescriptive than the SFA which includes various operational requirements in the act itself. The operational requirements will be included in supporting Regulations in the form of Legal Notices issued under Ministerial power and in the form of Rules issued by the Competent Authority. There have been accordingly various changes with reference to the SFA including the removal, grouping or rewording of certain articles currently found under the SFA and the introduction of new articles, as explained further below.

  The drafting approach adopted for the RPA is similar to the one under the Investment Services Act, 1994. The RPA has also been aligned, where relevant, with the recent amendments to the Investment Services Act.

  The proposed Bill is structured into eight Parts and a Schedule. Part I includes definitions for the terminology used; Part II relates to the licensing and recognition requirements; Part III to the application requirements for licences and recognition, and provisions relating to the granting and revocation of licences and recognitions; Part IV deals with governance requirements; Part V includes other requirements and general provisions; Part VI relates to powers to make regulations; Part VII deals with regulatory and investigatory powers; Part VIII relates to appeals, remedies, sanctions and confidentiality and Part IX is a miscellaneous section. The schedules to the current SFA have been removed and a new schedule introduced with details of the licensable activities for service providers.

- *Change in terminology*
  - Instead of reference to "Directives" (guidelines), the proposed Bill now refers to "Pension Rules", which are operational rules issued by the Competent Authority applicable to retirement schemes, retirement funds and service providers captured under the act.

  - The term "registration" is being replaced with the term "licence". The term "licence holder" has also been introduced, capturing licensed retirement schemes, licensed retirement funds and licensed service-providers.

- *Definitions*: The definitions section in the Bill marks an extensively revised section than that included in the SFA:
  - Various definitions were amended, such as the definitions of 'advertisements', 'scheme document', 'retirement benefit', 'contributor', 'beneficiary', 'overseas retirement plan' and 'occupational retirement plan';

  - Certain definitions including 'biometric risks', 'affiliate', 'ancillary cash', 'commissioner of Inland revenue', 'retirement fund administrator' and 'permanent invalidity' were deleted since these were not utilised in the Bill;

  - Certain definitions were replaced by new ones in view of the revision of certain terminology, including definitions of 'registration', 'asset manager', 'investment service';

  - A number of new definitions were introduced, including the definition of 'member', 'personal retirement schemes', 'document or documentation' , 'qualifying shareholder' and 'overseas regulatory competent authority';

  - The detail in the definition of scheme was moved to a new article in the proposed act.

- *Retirement Schemes / Retirement Funds*: In contrast with the SFA, Retirement Schemes and Retirements have been catered for separately in the Bill for greater clarity.

- *Different* legal *forms for Retirement Schemes and Retirement Funds* – The Bill does not prescribe that retirement schemes must be established by contract (as per current SFA) but provides that the Competent Authority may issue Rules regarding the legal form of establishment of retirement schemes. The idea is that it will be possible for retirement schemes to be established not only by contract or trust but also in a corporate form by way of a SICAV constituted by Memorandum and Articles of association under Company Law. This will reflect the various legal forms available for the establishment of retirement schemes also in other jurisdictions, providing more operational flexibility to the market.

The Bill also allows retirement funds to take legal forms other than the corporate vehicle currently provided for under the SFA. As for retirement schemes, the choice of legal form for retirement funds will also be dealt with in detail in Rules issued by the Competent Authority.

- *Service Providers*:
  - The SFA names the entities providing services to Retirement Schemes or Retirement Funds individually in the Act. Rather than following this drafting approach, the Bill introduces the term "service providers" to capture all entities providing services to retirement schemes, retirement funds or to equivalent arrangements overseas in or from within Malta. The Bill then lists all licensable activities in a Schedule to the proposed act. This approach allows the grouping of articles in the act common to all service-providers as well as, where relevant, to licensed retirement schemes and retirement funds and applied thereto collectively. Such articles relate for example to the granting and revocation of licences and recognitions, governance requirements etc.

  - The list of service providers has been revised and now includes:
    - *Retirement Scheme Administrators* - The definition of "retirement scheme administrator" has been amended to reflect more the role of a governing body responsible for the overall operation of the retirement scheme.

    - *Retirement Scheme / Fund Asset Managers* – this is similar to the current SFA.

    - *Retirement Scheme / Fund Custodians* – the reference to a Retirement Scheme Custodian is new, introduced since Retirement Schemes could no longer be required to invest through a Retirement Fund following the transposition of the EU Pensions Directive. The Bill also introduces a specific reference to Retirement Fund Custodian, which under the current SFA is catered for by way of Legal Notice.

    - *Back-Office Administrators* which will require recognition under the Bill. This is a new area which is not catered for under the SFA. Further details on back-office administrative activities and the applicable recognition requirements will be included in Pension Rules to be issued by the competent authority under the RPA.

  To note that:
    - the provision of advice on a non-discretionary basis has been removed since this activity is captured under MIFID;

    - the concept of a "retirement fund administrator" has been removed in order for the law to be less prescriptive with respect to retirement funds. The governance of retirement funds will be dealt with in more detail in Rules issued by the Competent Authority.

- *Powers to issue Regulations and Rules*: The powers to make regulations and rules have been reviewed, revised and grouped in one section under the Bill, rather than included throughout the act.

- *New articles* have been introduced in the Bill as follows:
  - the power of the competent authority to refuse or grant a licence and, or recognition for Service-Providers;

- the power of competent authority to cancel or suspend a licence or recognition for Service Providers;
- notification of proposed refusal, variation, cancellation or suspension of a licence and, or recognition;
- the opportunity of licence holders and recognised persons under the act to appeal from any decision of the Competent Authority.

▪ *Regulatory and Investigatory Powers*: The section regarding the regulatory and investigatory powers has been revised and updated.

▪ A section of the Bill has dedicated to governance of Retirement Schemes and Retirement Funds grouping articles related to this area.

▪ Detailed Requirements deleted or removed from the act to be catered for either by way of Legal Notices / Regulations or Rules issued by the Competent Authority include:

- The contents of the scheme document which will be included in Rules issued by the Competent Authority
- Details regarding the Technical Funding Requirement, Schedule of Payments and Under/Over Funding are to be included in Legal Notices to be issued under the new law if the Bill is enacted.
- Details regarding the reporting requirements and contents of annual reports of retirement funds which will be catered for in Rules issued by the Competent Authority
- The requirement for a minimum of three directors for a Retirement Fund has been deleted.
- Specific duties of the Retirement Scheme Administrator which will be stipulated in Rules issued by the Competent Authority.
- The investment and borrowing powers of a Retirement Scheme and Retirement Fund which will be detailed in Rules issued by the Competent Authority.
- The instances where a scheme document is binding or non-binding which will be detailed in Rules issued by the Competent Authority.

▪ The article regarding payment or non-payment of contributions has been updated to reflect local current legal procedures.

03 Consequential Amendments to other Acts

▪ Article 84 and 194 as well as the Fifth Schedule in the Companies Act (Cap. 386) will need to be amended to reflect the possibility for Retirement Schemes to be set up as SICAVs – given the new possibility for retirement schemes to also adopt this legal form. The revisions are also necessary in order for the articles in question to reflect the new name of the Bill.

▪ The following articles in the Trust and Trustees Act (Cap. 331) will need to be amended as follows:
  - Article 2, definition of 'unit trust' will need to be amended to refer also to unit trusts established in terms of the new act given that retirement schemes can be established as unit trusts;

- The reference to the Special Funds (Regulation) Act in Article 43(6)(c) needs to be revised to reflect the new name of the proposed act;
- Article 57(1)(h) needs to be amended to refer also to the new proposed act.

Appendix 05: Use of Property Retirement

Executive Summary

This Paper is an update of the paper titled: "*Use of Property for Retirement*" that was issued as a supplement to the Final Report of the Pensions Working Group on 30th June, 2005 ("2005 Property Paper"). It aims to: [i] take into account any changes in the social, economic and demographic scenarios since the publication of the 2005 Property Paper, and [ii] to reassess the validity of the recommendations of the 2005 Property Paper in terms of the current scenario. Moreover, the paper tries to determine whether: [i] property savings is a viable alternative source of retirement income; and [ii] property can be used to fund retirement income.

The Paper looks briefly at savings of residents in Malta. However an analysis of the savings patterns is limited due to lack of certain data. Accordingly although statistics indicate an increase in savings (e.g. in bank deposits and in financial instruments listed on the Malta Stock Exchange) by residents in Malta over the years, this cannot be taken to necessarily mean a general increase in the average savings household ratio.

The Paper also analyses briefly statistics regarding household debts (which is another form of savings) and property prices and ownership. Findings indicate that total resident lending for home purchases and the number of owned dwellings have been on the increase over the years. Moreover, when compared with other European Union countries, Malta ranks among the top countries with a high percentage of owner occupied property. Statistics seem to indicate that an element of savings have been targeted towards housing. In addition, while no data is available as to what percentage of household assets are in housing assets, it is likely that housing assets may represent a high percentage of household wealth given the trend of rising property prices in Malta over the recent years.

However, most housing wealth is different from other forms of wealth or savings. When compared with other forms of savings, property is indivisible and cannot be sold in separate units and the price of property appears to be established in an informal manner as there is no well established and regulated trading market for property. The impact of use of property for retirement income is uncertain and would be unevenly distributed:

- There are various reasons while people may not want to release equity locked in their property.
- Even if equity in property is released, it will not there is no guarantee that such income will be channelled to finance retirement income.
- In addition, the spread of wealth including housing wealth is likely to be uneven and unequal.
- Variation in house values and holdings of dwelling types among income earners leads to wide variations in the amount of property equity that can be released by different categories of people.
- Moreover, equity in property has a fluctuating value like other investments despite the general idea that property prices do not go down in Malta.

It is thus considered that savings in property and housing assets should not be considered as a substitute to other supplementary forms of or Second and Third Pillar pension provisions, but rather as assets that individuals can use to supplement their private pension savings should they so wish.

Financial products such as equity release products enable a home owner to draw down some of the equity held in property without the need to move out of the property. There are two main forms of equity release products namely, Home Reversion Schemes and Lifetime Mortgages. Research showed that equity release products are available in a number of countries worldwide. Moreover, three European Union Member States have a well developed equity release market and a limited form of such products are available in another nine Member States. The most developed equity release market is the United Kingdom where this has been present for over thirty years. The Paper provides an overview of the equity release market in this country, together with a synopsis of the regulatory framework for lifetime mortgages and home reversion plans applicable for products marketed in this country.

In so far as the local market is concerned, according to a Perceptions Survey carried out in 2005, although saving in housing appears to be increasing, only few people at the time appeared to plan or saw their property as a potential source of retirement income. However, the increase in: [i] the average age of the Maltese population due to an increase in the older age groups, and [ii] the number of single person households, may lead to the development of the equity release market in Malta. Equity Release Plans may prove attractive in due course, to certain segments of the population in Malta which are on the increase and to whom these plans are ordinarily attractive outside of Malta, such as single persons, childless couples and elderly people living independently rather than with their family. These demographic changes in households and the population, coupled with a high home-ownership percentage, and possibly a culture change towards property, may lead to the emergence of equity release markets in due course.

Recommendations:

i. Property should not be seen as a substitute source of retirement income to Second and Third Pillar pensions – but rather as a complement thereto;
ii. A detailed study should be carried out in due course to assess the potential for the development of an Equity Release market in Malta. In this regard,
    a. further research on the savings pattern of the Maltese population should be carried out with the aim of: [i] identifying Malta's savings ratio; [ii] the portion of an individual's wealth which is invested in property; and [iii] determining any existing arrangements which contain elements of equity release schemes;
    b. an assessment on the take up of such products by the Maltese population should be carried out. This assessment could *inter alia* analyse: [i] the impact of the Maltese traits and perceptions on giving up their property for future income; [ii] the cost of an awareness and educative campaign aimed at introducing such products in Malta; and [iii] the negative impact of adverse fluctuations in property prices which could have on consumers of such products. Moreover, the impact assessment should also incorporate any trends in the rental market, which might be brought about by the rent reform;

iii. The taxation and inheritance aspects would also need to be looked into.

iv. If demand for Equity Release products results, it is recommended that further research is carried out regarding the need or otherwise of a regulatory regime for such plans. The introduction of legislation in this area should be accompanied by a cost benefit analysis especially if research shows that there will be a limited market in such products.

v. A supporting educational campaign should accompany at any time any availability of these types of products.

01. Introduction

01.1 Purpose

This Paper is an update of the paper titled: "*Use of Property for Retirement*" ("*the 2005 Property Paper*") that was issued as a supplement to the Final Report of the Pensions Working Group on 30th June, 2005 ("*the 2005 Final Report*").

01.2 Background

Recommendation 44 in the 2005 Final Report advocated that "*the financial services market should offer regulated Property Pension Funds as a Third Pillar Product*". This recommendation was made following consideration of:

a. the feedback received during the consultation process on a White Paper that was issued in November 2004. Section 3.6.3 from the 2005 Final Report is attached as Appendix I to this Paper.
b. the findings of the 2005 Property Paper. The Executive Summary of this Paper is attached as Appendix II to this Paper.

01.3 Aims of the Paper

This Paper aims to:

a. take into account any changes in the Maltese social, economic and demographic scenarios since the publication of the 2005 Property Paper, and
b. to reassess the validity of the recommendations of the 2005 Property Paper in terms of the current local scenario.

The paper is aimed at determining whether: [i] property savings is a viable alternative source of retirement income; and [ii] property can be used to fund retirement income.

This Paper is not linked to the rent reform which area falls outside the scope of this Paper.

01.4 Structure of the Paper

The Paper is structured as follows:

- Chapter 02 considers: [i] the savings patterns of Maltese households; [ii] total resident household debt in Malta; and [iii] Malta's property prices and home ownership trends.
- Chapter 03 discusses the different ways of how property can be used to supplement retirement income;
- Chapter 04 looks at the equity release market and its regulation in the United Kingdom;
- Chapter 05 looks at the possibility of introducing equity release products in Malta; and
- Chapter 06 concludes with recommendations and way forward.

02. Savings and Property in Malta

02.1 Introduction

This section of the Paper attempts to analyse the savings patterns (including in the property sector) by Maltese residents. The first part provides an indication of the per capita deposits of the Maltese resident population with local credit institutions and also takes a look at the investments held by individuals in financial instruments listed on the Malta Stock Exchange and gross premiums written by individuals in the life insurance sector. This is followed by a look at the total resident household debt (which is another form of savings) in Malta together with an analysis of Malta's property prices and home ownership patterns. This chapter concludes whether housing wealth in Malta could be a potential source of retirement income.

02.2 Deposits

The personal sector wealth held in resident deposits with all local credit institutions as at 30th September, 2008 stood at EUR 6.6783 billion. As can be seen in Table 01, statistics show that total deposits by households and non-profit institutions resident in Malta has registered an increase in all years since 1985, with the exception of 1986. Per capita deposits registered a double digit increase between the years 1988 – 1997, and during 2007.

Table 01: Deposits of households and non-profit institutions resident in Malta with all local credit institutions

Year	***Total Deposits by households and non-profit institutions EUR 000s***	***Total Population***	***Per capita deposits***	***%age change over previous year***
1985	845,171.21	340,907	2.48	
1986	837,663.64	343,514	2.44	-1.64%
1987	924,477.06	345,636	2.67	9.69%
1988	1,054,949.92	349,014	3.02	13.01%
1989	1,218,718.84	352,430	3.46	14.40%
1990	1,419,808.99	355,910	3.99	15.36%
1991	1,588,236.66	359,543	4.42	10.73%
1992	1,786,049.38	362,977	4.92	11.39%
1993	2,044,894.01	366,431	5.58	13.41%
1994	2,398,430.00	369,451	6.49	16.33%
1995	2,726,857.68	371,173	7.35	13.17%
1996	3,079,808.99	373,958	8.24	12.10%
1997	3,414,887.03	376,513	9.07	10.13%
1998	3,762,068.48	378,518	9.94	9.58%
1999	3,970,810.62	380,201	10.44	5.08%
2000	4,162,068.48	382,525	10.88	4.18%

Source: National Statistics Office / Central Bank of Malta

Table 01 contd.: Deposits of households and non-profit institutions resident in Malta with all local credit institutions

Year	*Total Deposits by households and non-profit institutions EUR 000s*	*Total Population*	*Per capita deposits*	*%age change over previous year*
2001	4,555,828.09	385,077	11.83	8.74%
2002	4,941,921.73	386,938	12.77	7.95%
2003[1]	5,078,826.00	388,867	13.06	2.26%
2004	5,199,700.00	390,669	13.31	1.91%
2005	5,361,300.00	392,560	13.66	2.61%
2006	5,687,300.00	393,933	14.44	5.71%
2007	6,541,800.00	394,830	16.57	14.76%
2008	6,678,300.00*	396,710**	16.83	1.60%

Source: National Statistics Office / Central Bank of Malta

[1] Since October 2003, the compilation of deposits has been harmonised with internationally agreed statistical concepts. This sector, from 2003, comprises individuals and non-profit institutions.
[2]Total deposits for 2008 related to figures as at 30th September, 2008
[3]Total population for 2008 was not available. An estimate for 2008 has been calculated by taking a simple average of the percentage increase in population over the previous ten years.

02.3 Other Forms of Savings

02.3.1 Investments in Instruments listed on the Malta Stock Exchange

Table 02 shows the total investments in financial instruments listed on the Malta Stock Exchange ("*MSE*")[65] by residents of Malta and the number of Maltese resident individuals holding an account with the MSE per annum. The statistics show that the level of savings in investments on the MSE listed instruments has increased at a steady pace from 2001 to 2008. Furthermore, it appears that a sizeable amount of the Maltese population appears to have some form of investment on instruments listed on the MSE.

[65] The MSE is the only regulated market on the Maltese Islands for dealing in financial products, including: equities and bonds issued by the government and the private sector and treasury bills issued by the government of Malta.

Table 02: Investments by residents of Malta on the MSE

Year	*Type of Financial Instrument*					*Number of Resident Individuals*
	Malta Government Bonds	***Bonds***	***Equities***	***Treasury Bills***	***Total***	
	EUR	*EUR*	*EUR*	*EUR*	*EUR*	
2004	314,256,900	137,616,700	98,543,109	-	550,416,709	166,183
2005	337,339,900	121,927,200	113,737,857	-	573,004,957	163,784
2006	322,208,900	135,336,600	185,284,466	-	642,829,966	162,001
2007	325,279,100	184,193,200	204,671,284	8,347,000	722,490,584	171,194
2008	788,621,655	348,800,501	250,910,346	56,442,000	1,444,774,502	179,702

Source: Malta Stock Exchange

02.3.2 Other forms of Savings

Further to the above, to also note that there could be other alternative forms of financial savings such as shareholders' funds in locally based collective investment schemes and other entities not listed on the Malta Stock Exchangeinsurance products as well as savings in and/or with foreign based entities. First hand comparative statistics over a period of time with respect to these forms of savings were not readily available (although one notes that total gross premiums written from all classes of long term business, excluding group life policies, for 2007 amounted to EUR 225,207m).

So although the above statistics seem to indicate that savings have increased steadily by residents in Malta over the past years, no meaningful analysis can be carried out. In this regard it is important to note that no data is available on how the above savings (deposits or investments in MSE listed instruments) are spread among individuals and whether these are representative of the population or of which sectors of the population.

In addition, the value of investments / savings in MSE listed instruments can go up or down depending on the performance of the underlying market.

Another limitation is the lack of readily available data regarding Consumer's Expenditure or Disposable Income patterns. In this regard, it should be noted that Table 02 in the 2005 Property Report indicated a decreasing trend in the savings ratio from 1985 to 2002. At the time, this decrease in savings ratio indicated *prima facie* that people were saving less in relation to consumption and disposable income, especially since inflation rate was on the increase. Moreover, statistics then showed an increase in household debt (servicing of which carries a cost which impinges on disposable income), with a lower growth in 2004 in disposable income coupled with a slowdown in private consumption. Unfortunately similar data for recent years is not available.

Therefore, although statistics tend of show increasing levels of savings, this cannot be taken to necessarily mean that on average households are saving more over the years.

02.4 Household Debt and Property Ownership

Table 03 below shows an increasing trend in the total amount of house loans (which can be considered as another form of savings) over the years 1985 to 2008, albeit at a decreasing rate from 2005 to 2008, with a marked slowdown in 2008 reaching 7.52%.

Table 03: House Loans to resident householders with all credit institutions.

Year	***Total Resident Lending for House Purchases***	***% age change over previous year***
	EUR 000s	
1985	87,798.74	
1986	97,943.16	11.55%
1987	108,287.91	10.56%
1988	126,606.10	16.92%
1989	150,104.82	18.56%
1990	180,125.79	20.00%
1991	196,662.01	9.18%
1992	219,629.63	11.68%
1993	230,340.09	4.88%
1994	279,597.02	21.38%
1995	308,779.41	10.44%
1996	352,122.06	14.04%
1997	404,588.87	14.90%
1998	454,353.60	12.30%
1999	521,986.96	14.89%
2000	600,845.56	15.11%
2001	714,470.07	18.91%
2002	855,168.88	19.69%
2003	1,030,153.74	20.46%
2004	1,255,700.00	21.89%
2005	1,521,400.00	21.16%
2006	1,769,900.00	16.33%
2007	2,014,900.00	13.84%
2008*	2,166,500.00	7.52%

Source: National Statistics Office / Central Bank of Malta

* Figures available as at 30th September, 2008.

Lending for house purchases remains one of the primary purposes of bank borrowing by residents according to the Annual Report of the Central Bank of Malta for 2008 (despite having slowed down during the twelve months to December 2008).

One may argue that this can be further substantiated by the number of owned dwellings. The Census of the Population and Housing undertaken in 2005, showed that 75.2% of occupied dwellings were owned, an increase of 28.76% from the number of owner occupied dwellings in 1995. Table 04 illustrates the distribution of occupied dwellings by tenancy which shows a marked preference for home ownership (approx. 70%) against renting of dwellings (approx. 20%). Furthermore, this table shows that owning a property may not always be a choice due to the current problems associated with the rental market

Table 04: Occupied dwellings by tenancy

Tenancy	***1995***		***2005***	
	Number	%	Number	%
Owned Freehold	81,242	68.00	76,689	55.10
Owned with ground rent			27,922	20.10
Rented Unfurnished	30,824	25.80	24,383	17.50
Rented Furnished	2,957	2.50	4,377	3.10
Held by emphyteusis	-	-	2,112	1.50
Used free-of-charge	4,407	3.70	3,695	2.70
Non-respondent	49	0.00	-	-
	119,479	100	**139,178**	100

Source: Census of Population and Housing 2005 - Volume 2 – Dwellings

When comparing with other EU member states, Malta tends to rank with the countries which have high percentages of owner occupied property. Table 05, which has been reproduced from a report titled: "*Housing statistics in the European Union*" compiled by the National Board of Housing, Building and Planning, Sweden and the Ministry for Regional Development of the Czech Republic contains the distribution of occupied dwelling stock by tenure across EU member states.

Table 05: Occupied dwellings by tenancy in the EU

3.5 Occupied dwelling stock by tenure (%), *1980–2003*

	1980				1990				1995				2000				2003			
	R	OO	CO	O	R	OO	CO	O	R	OO	CO	O	R	OO	CO	O	R	OO	CO	O
Austria[1]	43	52	na	5	41	55	na	4	42	54	na	4	na	na	na	na	39	58	na	3
Belgium[1]	38 [2]	59 [2]	na	3 [2]	33 [2]	67 [2]	na	0 [2]	na	na	na	na	32	68	na	0	31 [2]	68 [2]	na	2 [2]
Cyprus[6]	16 [2]	61 [2]	na	23 [2]	13 [2]	64 [2]	na	23 [2]	na	na	na	na	14 [2]	68 [2]	na	18 [2]	na	na	na	na
Czech Republic[7]	40	40	13	7	40	38	19	3	na	na	na	na	29	47	17	7	na	na	na	na
Denmark	43	55	1	1	40	54	5	1	40	52	6	2	39	52	7	2	40	53	7	0
Estonia	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na	na
Finland	30	63	0	7	25	72	0	3	30	67	0	3	32	64	0	4	34	63	0	3
France[4]	41 [2]	47 [2]	na	12 [2]	39	54	na	7	40 [2]	54 [2]	na	7 [2]	39 [2]	55 [2]	na	7 [2]	38 [2]	56 [2]	na	6 [2]
Germany[3]	61	39	na	0	58 [2]	42 [2]	na	0 [2]	57 [2]	43 [2]	na	0 [2]	na	na	na	na	55 [2]	45 [2]	na	0 [2]
Ex-GDR	69 [2]	31 [2]	na	0 [2]	74 [2]	26 [2]	na	0 [2]	69 [2]	31 [2]	na	0 [2]	na	na	na	na	66 [2]	34 [2]	na	0 [2]
Greece	25 [2]	75 [2]	na	0 [2]	24 [2]	76 [2]	na	0 [2]	na	na	na	na	20 [2]	74 [2]	na	6 [2]	20 [2]	74 [2]	na	6 [2]
Hungary[8]	29	71	na	0	26	74	na	0	20	79	na	1	7	92	na	1	7	92	na	1
Ireland[1]	24	76	na	0	18 [2]	79 [2]	na	3 [2]	na	na	na	na	na	na	na	na	18 [2]	77 [2]	na	5 [2]
Italy	36	59	na	5	25 [2]	68 [2]	na	6 [2]	na	na	na	na	na	na	na	na	na	na	na	na
Latvia	na	na	na	na	79	21	na	0	58	42	na	0	30	70	0	0	21	79	0	0
Lithuania[5]	na	na	na	na	na	na	na	na	na	na	na	na	7	91	na	na	na	na	na	na
Luxembourg	39 [2]	60 [2]	na	1 [2]	30	64	na	6	26 [2]	70 [2]	na	4 [2]	26 [2]	70 [2]	na	4 [2]	26 [2]	67 [2]	na	7 [2]
Malta	na	na	na	na	na	na	na	na	28	68	na	4	na	na	na	na	26 [2]	70 [2]	na	4 [2]
Netherlands[4]	58	42	na	0	55	45	na	0	52	48	na	0	47	53	na	0	45	55	na	0
Poland[10][11][12]	na	na	na	na	na	na	na	na	na	na	na	na	26	55	19	0	24	58	18	0
Portugal	39 [2]	52 [2]	na	5 [2]	28 [2]	67 [2]	na	5 [2]	na	na	na	na	21 [2]	75 [2]	na	4 [2]	na	na	na	na
Slovak Republic[9]	na	na	na	na	28	49	22	1	na	na	na	na	9	74	15	2	na	na	na	na
Slovenia	na	na	na	na	na	61	na	39	na	na	na	na	na	na	na	na	9	84	na	7
Spain	21 [2]	73 [2]	na	6 [2]	15 [2]	78 [2]	na	7 [2]	14	80	na	6	10	84	na	6	11	82	na	7
Sweden [1,13]	42	42	16	0	44	39	17	0	40	46	14	0	39	46	15	0	39 [2]	46 [2]	15 [2]	0
United Kingdom	42 [2]	58 [2]	na	0	35	65	na	0	33	67	na	0	31	69	na	0	31 [2]	69 [2]	na	0 [2]

R = Rent, OO = Owner-occupied, CO = Cooperative and O = Other

Other includes BE: (rent) free dwellings; ES: vacant or unknown dwellings; IT: free right of user; FR: tenancy of a furnished unit, sub tenancy and free housing; FI: empty dwellings.

1 BE, IE: occupied dwellings; AT: annual average; principal dwellings
2 BE: 1981, 1991, 2002; CY: 1982, 1992, 2001; DE: 1993, 1998, 2002; ES: 1981, 1991; Ex-GDR: 1981, 1993, 1998, 2002; GR: 1981, 1991, 1999, 2001; FR: 1978, 1996, 1999, 2002; IE: 1991, 2002; IT: 1991; LU: 1981, 1997, 2001, 2002; MT: 2002; PT: 1981, 1991, 2001; SE: 2001; UK: 1981, 2001
3 Excluding Ex-GDR
4 Refers to stock statistics given in Table 3.1
5 Population and Housing Census 2001. Data on occupied conventional dwellings. The tenure status of 2 % of the dwellings are not indicated
6 1982 and 1992: Households, 2001: Conventional dwellings
7 Population and Housing Census: 1.11.1980, 3.3.1991, 1.3.2001
8 1995=1996 Micro census, 2000=2001 Census, 2003: Housing Survey
9 Population and Housing Census: 3.3.1991, 26.5.2001
10 The rental category embraces housing stock of: municipalities, social housing associations, co-operatives (so-called rental title) and employers
11 Dwellings owned by natural persons. Data on the base of current reporting
12 Co-operative dwelling: The category embraces housing stock of co-operatives (ownership title only)
13 Co-oprative dwellings: Housing co-operatives based on tenant-owning. A small fraction (<1% of total dwelling stock) consists of co-operative rental dwellings

Source: National statistical institutes, Ireland: Department of the Environment, Heritage and Local Government

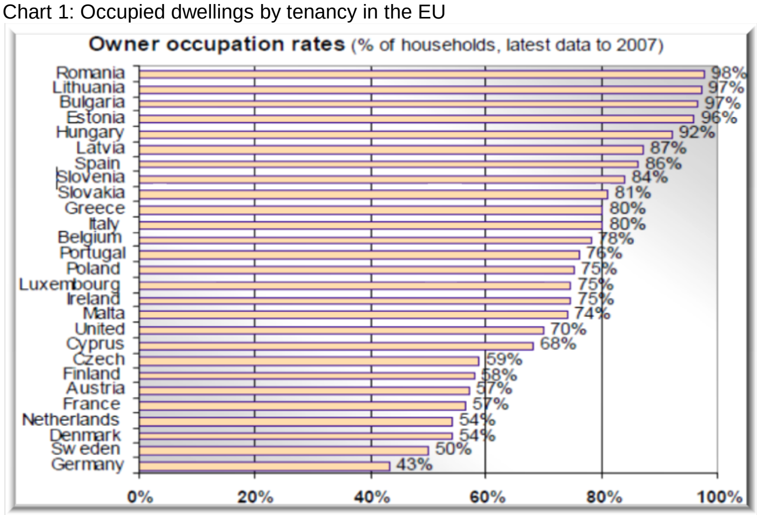
Source: National Board of Housing, Building and Planning, Sweden and the Ministry for Regional Development of the Czech Republic

Similarly Chart 1 which has been reproduced from a report titled: "*Study on Equity Release in the EU"* conducted by the European Commission provides an indication of the owner occupancy rates in the EU. The chart indicates that levels of homeownership vary considerably in the European Union, with countries of the southern and eastern Europe, which tend to be less industrialised have high homeownership rates, while the traditionally more industrialised member states have more significant tenant occupation.[66]

From the above, it appears safe to conclude that Malta's proportion of owner occupied property tends to be on the high side. These figures seem to suggest that rented property is not very popular in Malta. This notwithstanding, the impact of the rent reform should not be discounted as potentially it could bring about a shift from home ownership to rental of property over time. One would also need to look at demographic composition and changes in this regard.

[66] Study on Equity Release Schemes in the EU pg. 50.

Chart 1: Occupied dwellings by tenancy in the EU



Source: EMF/Hypostat 2007 A Review of Europe's Mortgage and Housing Markets, 11/2008, Statistical Tables

02.5 Property Prices

The 2005 Property Report noted that although a considerable percentage of the Maltese population's expenditure was being directed towards acquiring property both as a personal and long term asset, the increase in total resident lending for house purchases corresponded to a matching increase in property prices. Table 03 and Table 06 of this Report appear to reaffirm this observation.

Table 06 illustrates the changes in the property index for the years 2000 to 2008, with the year 2000 being the base year. This table shows an increase in property prices up to 2007, albeit with property prices increasing at a slower rate between 2005 and 2007, followed by a decrease of 2.68% in 2008 – which patterns appear to be reflected also in Table 03 with respect to total credit granted by credit institutions for house purchases.

Table 06: Property Price Index (Based on advertised prices)

Period	***Index of house prices***
2000	100.0
2001	105.1
2002	114.2
2003	129.3
2004	155.6
2005	170.9
2006	177.0
2007	178.9
2008	174.1

Source: Central Bank of Malta

This similarity in pattern between Table 03 and Table 06 indicates a possible correlation between the index of house prices and total resident lending for house purchases. [However it is worthwhile noting that Table 03 shows a fluctuating pattern in household lending for the period 1991 to 1998. However no property price data is available for that period other than Table 06 which shows a general increase in house prices. Therefore one cannot conclude – without full data – that the observation that increases in house mortgages corresponds to property prices as being conclusive].

This possible correlation between the amount of house loans and property prices could be interpreted to merely mean that the amount of house loans taken out reflects the property prices for that sector, where the acquisition of a property may not necessarily be an investment but is a necessity (especially given the problems associated with the local rental sector during the past years and the cultural preference for home ownership).

However this possible correlation between the amount of house loans and property prices could include a sector who is directing savings into property as a long term investment[67]. The reduction in house loans in comparison with a decreasing trend in property prices could also include a sector who was investing in property not out of necessity but as an alternative form of investment, and who is now channelling savings previously allocated to property into other forms of investment. In this regard, it may also be worthwhile to note that the savings trends in bank deposits and investments held by nominal individuals on the Malta Stock Exchange, according to Tables 01 and 02 increased substantially during 2004 – 2008, in comparison with the decrease in house loans and property prices over the same period.

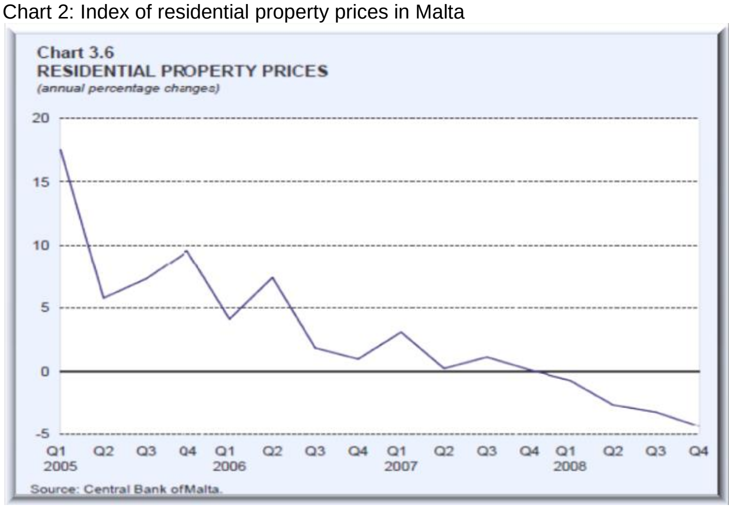
Ideally the amount of house loans should be assessed in relation to the actual number of house loans and categories of house-buyers taking out the loans (e.g. first-time buyers vs. second time buyers) and the demography of the population.

Table 06 above, also appears to challenge the general notion that an investment in property in Malta is always appreciating and that property prices are always on the increase. In this regard, to note that the Annual Report of the Central Bank of Malta for 2008 indicates that the index of advertised residential property indicated an average decline of 2.7% in 2008[68]. The same report states that the decline was spread across the various property types. Chart 2 which reproduces Chart 3.6 of the same report shows the decline in residential property prices between 2005 and 2008.

[67] Structure Plan for the Maltese Islands – a Housing Topic Paper dated February 2004, indicates that (page 58) "further loans are being issued for clients buying property as an investment rather than a home". Data in this Report shows that the number of vacant properties had increased up to 2004. In 1995 vacant property amounted to 23% of total. And between 1985 and 1995, there was an increase of 11,668 vacant units. The 1997 census indicated that 36% of these vacant properties are used as summer residencies while others are permanently vacant.

[68] Annual Report 2008 – Central Bank of Malta pg. 41.

Chart 2: Index of residential property prices in Malta



Further to the above, due to lack of availability of specific data, it is difficult to determine exactly how much is saved in property versus other alternative forms of investment. This notwithstanding, there still appears to be an element of savings being targeted towards housing and that property may be a major asset for certain households – as substantiated by the amount of house loans taken out and also by the high home ownership rate that exists in Malta.

02.6 Is Housing wealth a suitable source of retirement income?

Most housing wealth is different from other forms of wealth or savings. Unlike other forms of investment, property is indivisible and cannot be sold in separate units. Moreover, there is no well established and regulated trading market, which determines the market value of property on a frequent and regular basis – prices of property seem to be established in an informal manner.

Moreover, housing is one of the basic social needs and people may not necessarily own property for speculation or as an investment. Home ownership provides security to tenants and helps to reduce the costs of residency, rather than to provide a significant amount of income throughout retirement, unless the individual holds more than one property.

There is a cost with releasing residential property – as alternative accommodation would need to be found. Not all homeowners necessarily own more than one property. Moreover, property very often carries with it an emotional attachment and many people are reluctant to move house. Also, property is often seen as a family asset which should be preserved for their children or grandchildren. These factors may render the use of property for retirement as uncertain[69].

Moreover, even if equity in property is released, no definite rule exists that people will use it to finance retirement income rather than for other purchases or other needs such as health care. This means that not all housing wealth would actually be available to use or will be channelled to finance retirement[70], even if it may be large compared to financial wealth.

[69] Pensions Policy Institute (2004) Property or Pensions?

[70] Op cit Pensions Policy Institute (2004) Property or Pensions? Pg 6.

In addition, it is not documented how and where wealth is tied up – particularly how savings or house loans or dwelling types (which vary by price) are distributed among earnings categories. Variation in house values and holdings of dwelling types among income earners leads to wide variations in the amount of equity that can be released by different categories of people. It is likely that most people will have property and other forms of savings – but neither type of wealth is spread evenly among everyone. The majority of people would probably have low levels of savings and relatively small amounts of housing equity.

Only a proportion of the population will have: [i] sufficient housing equity to provide a reasonable amount of retirement income, together with other savings; and [ii] sufficient amounts invested in property to allow them to use investment income from property instead of private pension provision[71].

This section of the report attempted to give an indication of the savings patterns of the Maltese individuals. Indeed, the analysis is not comprehensive and it is not clear what are the savings patterns or what percentages of household assets are in housing assets and how these are held. In any case, even if housing assets feature as a large component of housing wealth, this percentage as well as the value of property held may fluctuate.

Further to the above, it is considered that savings in property and housing assets should not be considered as substitute retirement income to other supplementary forms of income or Second and Third Pillar pension provisions, but rather as assets that individuals can voluntarily use to supplement their private pensions should they so wish.

[71] Ibid pg 21.

03. How can Property supplement retirement income?

03.1 Introduction

One primary way property can be used to increase or fund income during retirement is through the sale of the house – the primary residence or a second property. However the equity received on the sale of the primary residence would be reduced by the purchase of another presumably smaller property, or by living costs of renting alternative accommodation or moving into a retirement home. In addition, this requires the homeowner to move out of the property.

Alternatively, there are a number of financial services products known as equity release mechanisms which are either mortgage or reversion based financial schemes, which enable a home owner to draw down some of the equity in the property.

Equity release products have become increasingly popular in a number of countries. Such products are available in countries within the European Union ("*EU*"), and other countries such as: Australia, Canada, France, New Zealand, South Africa, and the United States of America. A study on equity release schemes in the EU undertaken by the European Commission ("COM") shows that the equity release market is well developed in the: [i] United Kingdom; [ii] Spain; and [iii] Ireland. Another seven member states have equity release markets but which generally contain offers for lifetime mortgage loans these being: [i] Austria; [ii] Finland; [iii] France; [iv] Germany; [v] Hungary; [vi] Italy; and [vii] Sweden. Moreover, Bulgaria and Romania have a small scale market of the home reversion model plans. No equity release scheme market exist in the remaining member states. The COM's document is attached as Appendices III and IV to this paper.

The COM's study revealed that the United Kingdom has the highest number of equity release contracts in issue. It also indicated that the market of the lifetime mortgage loans represents approximately 0.1% of the ordinary mortgage market. Moreover the EU outstanding lifetime mortgage market as at 2007 was around EUR 3.31 billion with an estimated 45,328 contracts. It also indicated that equity release products are primarily issued by: [i] credit institutions (40%); [ii] real estate investors (19%); [iii] specialist lenders (12%); [iv] insurance companies (12%); and [v] the remaining 15% being markets by intermediaries operating on behalf of product providers.

This section of the report outlines the various equity release plans available in the United Kingdom, which appears to be the most developed markets within the EU.

03.2 Equity Release Plans in the United Kingdom

Equity Release Plans are defined as: "*financial products, or sale and lease arrangements, that allow home owners to release the value of their property above any amount owed on a mortgage. These schemes involve a provider giving the home owner either a lump sum or income (or both) on the basis of the value of the home. Providers receive their returns when the home is sold or vacated.*"[72] There are two main types of Equity Release Plans: [i] Home Reversion Schemes; and [ii] Lifetime Mortgages / Mortgage-Backed Equity Release Plans.

03.2.1 Home Reversion Schemes

A home reversion plan is an arrangement between a plan provider and home owner, comprising of one or more instruments or agreements, in which a plan provider buys all or part of a qualifying interest in property at a discount, in return for a lump sum payment or a regular income but the home owner retains the right to continue living in the property until the earlier of either death or moving to another property. Under this agreement, the home owner would no longer remain the owner of part or all of the property that is sold. The plan provider would either own the property itself or find an investor for the property.

[72] HM Treasury (2003) Regulating Home Reversion Plans – Consultation Document UK pg. 3.

The lump sum generated from the sale of property *inter alia* depends on: [i] the age of the owner/s; [ii] an actuarial assessment of life expectancy; [iii] the value of the property. The lump sum may be drawn in whole or it could be invested into an annuity or some other type of investment which provides the home owner with a regular income. In the case where either the home owner or the joint home owners moves to a nursing home or dies, the plan will terminate and the property is sold.

Other characteristics of home reversion schemes include:

i. the home owner is responsible for maintenance of the property;
ii. the terms of the agreement giving the right of the home owner to continue living in his own home vary, with some contracts requiring the payment of rent by the home owner;
iii. the plan can be taken out in joint names whereby it remains in-force until the second partner dies or is no longer living in the house;
iv. the buyer of the property will benefit from an increase in property value;
v. professional and independent valuations of the property are important;
vi. total income paid out depends on the life expectancy of the home owner, i.e. the longer a person lives, the better the value obtained on the property; and
vii. these plans cannot be cancelled or reversed.

Table 07: The advantages and disadvantages associated with Home Reversion Plans

Advantages	***Disadvantages***
The plans provide a one-off lump sum substantial amount to spend or to invest.	The value of the assets will be reduced by a significant sum and so reduce the amount of inheritance for the heirs.
There are no on-going repayments to be made and the plan provider earns revenue when the property is sold.	The plan can turn out to be quite expensive if the home owner dies soon after taking out the plan. This implies that the home owner would have sold part or the entire house quite cheaply - given that the plan provider buys the property at a discount in return for the home owner to continue living in the house.
A share of the home will be left to the heirs unless the home owner sold the entire house to the plan provider.	Some plans take a long time to be finalised and some plan providers are selective on the property they take.
The home owner will continue to share in any increase in the value of the property for the amount that he/she retained (unless the entire value is sold to the reversion company).	The home owner will not gain from any increase in the value of the property on the portion sold. No gain is made if the property is sold entirely at the outset to the reversion company.
The home owner can take extra cash advances, depending on the amount taken at the outset.	The home owner will be responsible for the upkeep and maintenance of the house.

Source: Age Concern (2004): Raising income or capital from your home

03.2.2 Lifetime Mortgages

With a lifetime mortgage, the home owner takes out a mortgage loan secured on the property. The loan can be used to fund an annuity and provide regular income (such as an annuity) or a lump sum payment. Such financial products can include drawdowns which provide a regular income which is not linked to investments. The amount of the loan is based on the age of the owners, their life expectancy and the value of the property. Ownership remains with the home owner. The loan including interest is repaid when the property is sold either: [i] on the event of the home owner's death; or [ii] if the home owner moves into long-term care. However, some of these plans provide the option that the home owner pays interest on the loan and only the principal amount is paid when the property is sold. Lifetime mortgages can be paid off at any time but charges may apply. In the case of such plans the home owner retains ownership of the home.

There are five types of lifetime mortgages which include: [i] home income plans; [ii] interest-only mortgages; [iii] roll-up mortgages; [iv] shared appreciation mortgages; and [v] fixed repayment lifetime mortgages.

03.2.2.1 Home Income Plans

In terms of this product, a plan provider issues a loan (usually in cash) to the home owner against the value of his/her property. The lump sum is used to buy an annuity to provide regular income to the home owner. Interest on the loan is deducted from the regular income, usually at a fixed rate. Normally the lump sum which was originally issued by the plan provider is repaid when the home is sold usually after death of the home owner. Where the plan has been issued in joint names, the loan is repaid until death of both parties.[73]

This type of plan appeals to people aged around eighty as: [i] higher income obtained at this age; [ii] a higher annuity payment at distributed at this age, given the few years over which the income will need to be paid.

Table 08: The advantages and disadvantages associated with Home Income Plans

Advantages	***Disadvantages***
Provided a scheme with a fixed interest rate is chosen, the income will remain unchanged over the person's lifetime, subject to any changes in the tax rates.	Not suitable for persons requiring a substantial lump sum of money.
Ownership of property is retained, thus the home owner gains from future increases in its value (and similarly loose out from any fall in value.	If such products are not indexed, income from these plans may be negatively affected from inflation.
	This plan will reduce the value of the assets of the home owner. It may turn to be expensive if the home owner dies soon after taking out the plan unless protected to a certain extent through a capital protection plan.
	These plans are beneficial for older people who obtain better annuity rates as their life expectancy is shorter.

Source: Age Concern (2004): Raising income or capital from your home

03.2.2.2 Interest Only Mortgage

This type of product, allows the home owner to take out a cash lump sum against the value of the property. The home owner in turn pays interest on the loan on a monthly basis at either a fixed or variable rate. The amount originally borrowed is repaid when the property is sold. The disadvantages

[73] Age Concern (2004) Raising Income or Capital from your Home pg. 10.

associated with this mortgage are: [i] if interest rates are variable, one would be exposed to increases in the rate of interest and hence higher payments; and [ii] if one partner dies, the surviving partner may not be able to afford making interest payments.[74]

03.2.2.3 Roll-Up Mortgages

This type of mortgage allows a home owner to loan out a cash lump sum against the value of the property, which can either be taken as a lump sum or regular income. This type of contract requires no regular payment of interest, but interest is compounded on the principal amount of the loan. In this regard, the final amount payable either when selling the property or going to home care may be considerable when compared to the amount borrowed, given the compounding effect of this contract. The rates of interest on this type of contract may be fixed or variable.[75]

[74] Ibid pg. 13.
[75] Ibid pg.11.

Table 09: The advantages and disadvantages associated with Roll-up Mortgages

Advantages	***Disadvantages***
These contracts provide a home owner with a sum of money without the payment of interest.	The amount payable on repayment accumulates rapidly through the compounding of interest.
The home owner retains ownership of the property.	This contract reduces the value of the home owner's property and so reduces the amount left to the heirs.
These contracts are available to people aged 55 onwards.	Interest rates can be high as the rate is fixed for the life of the loan which may span a long time prior to repayment.
	These plans are beneficial for older people who obtain better annuity rates as their life expectancy is shorter.

Source: Age Concern (2004): Raising income or capital from your home

03.2.2.4 Shared Appreciation Mortgages

This type of product, allows the home owner to take out a cash lump sum against the value of the property. No interest is paid by the home owner on this type of contract but when the property is sold in addition to the principal payment, the plan provider gets an agreed percentage of the increase in the value of the property.[76]

03.2.2.5 Fixed Repayment Lifetime Mortgage

This type of product, allows the home owner to take out a cash lump sum against the value of the property. No interest is paid by the home owner on this type of contract but when the property is sold, the plan provider is repaid the principal amount and an additional fixed amount agreed at the outset. The amount payable depends on the age and life expectancy of the home owner. In the event that death of the home owner occurs prior to the repayment of the mortgage, the plan provider may require interest on the repayment sum from date of death to the date until the mortgage is repaid.[77]

[76] Ibid pg. 13.
[77] Ibid pg 13.

04. Equity Release Markets and Regulation

04.1 Introduction

The equity release market has been developed in the United Kingdom for the past thirty years and with the exception of Spain, but such products have only had a presence in the other EU Member States for five years or less. Therefore, equity release products are considered as a relatively new development in the EU. In this regard, this chapter will focus on the regulation of equity release products in the United Kingdom, given that this appears to be the most developed equity release market in Europe.

04.1 Equity Release Markets in the United Kingdom

In the United Kingdom, these products are used as a source of voluntary third pillar pension provision, namely targeting but not limited to those pensioners who receive a low pension and who may not necessarily have any other liquid savings.

The 2005 Property Paper indicated that there was no accurate information on the size of the equity release market in the United Kingdom at the time, and that conflicting information had appeared in the press about the total value of this market.[78] This notwithstanding, a 2004 report compiled by the Pensions Commission titled: "Pensions: Challenges & Choices".[79] estimated that at the time of writing of the report, in the United Kingdom only around 1% of pensioner householders were using these types of products given the: [i] higher interest rates associated with lifetime mortgages; [ii] the inherent risks of borrowing without knowing the maturity date of the loans; [iii] emotional attachment to property; [iv] the wish by many people to leave their property to their children.

In the meantime, the Safe Home Income Plans[80] ("SHIP") has issued certain industry statistics. Table 10 indicates that the value of home reversion plans in the UK expanded between 2004 and 2007. However, the financial crisis had a negative impact on this type of business, with a decline in value of 30.51% when compared with 2007. The equity release mortgage business in the UK registered moderate increases in the value of business in 2006 and 2007 with decreases in 2005 and 2008 when compared with the previous year.[81]

[78] HM Treasury (2003), Regulating Home Reversion Plans – Consultation Document, pg. 5.

[79] Pensions Commission (2004): Pensions: Challenges and Choices – The First Report pg. 194.

[80] SHIP is the United Kingdom's trade body for equity release product providers, representing the interests of its members who provide home income and equity release plans. It was launched in 1991 in direct response to the growing need for consumer protection. It represents the majority of the equity release market providers (over 90% of the equity release market in volume terms as at 31st December, 2008) in terms of volume and its members include the leading providers of lifetime mortgages and home reversion plans.

[81] The Safe Home Income Plans website available from: http://www.ship-ltd.org.

Table 10: The equity release market in the United Kingdom

Year	***Equity Release Mortgage Business***	***%age change over previous year***	***Home Reversion Plans***	***%age change over previous year***
	GBP'000s		GBP'000s	
2004	1,151.80		40.50	
2005	1,048.90	-8.93%	54.60	34.81%
2006	1,080.80	3.04%	73.50	34.62%
2007	1,127.80	4.35%	82.60	12.38%
2008	1,038.30	-7.94%	57.40	-30.51%

Source: The Safe Home Income Plans Website

Notwithstanding the figures reported above, figures for the first quarter 2009 released by SHIP indicate an increase in the total value of equity release business written. Moreover, the changes to the Pension Credit announced by the British government in 2009 allow pensioners to increase to £10,000 the amount they are allowed to have in savings without affecting their benefits. This measure is deemed in the UK that it could help the development of the equity release market by releasing some equity in the UK pensioners' property.

04.2 Regulation of the Equity Release Markets in the United Kingdom

04.2.1 Lifetime Mortgages

First charge Lifetime Mortgages have been regulated in the UK by the Financial Services Authority ("the FSA"), which is the single Regulator of financial services in the UK, since October 2004.

The specific regulatory requirements applicable to Lifetime Mortgages are targeted towards avoiding certain detrimental features that have surfaced in the past in the UK. As an example due to variable interest rates, people ended up owing more than their home was worth in total. In fact, post such scandals, SHIP required its member product providers to include 'no-negative' guarantees to cater against this risk. '*No-negative*' guarantees require product providers to guarantee plan holders that the value of the granted loans would not rise beyond the value of the property.

Regulation of Lifetime Mortgages in the UK is based namely on rules which instruct: [i] what providers must tell lifetime mortgage borrowers when they take out such plans, [ii] the competence of retail staff selling such mortgage plans and [iii] the internal control requirements of authorised firms.[82]

Specific rules on disclosure have been established, requiring firms to issue consumers with a "*key facts illustration*" in a standard format. In this way, consumers are able to compare products between themselves, and so consumers will be in a better position to take an informed decision about the most suitable product for them, reducing the likelihood of future mis-selling. The use of this standard "*key facts illustration*" contributes towards transparency of pricing, also encouraging competition.

[82] FSA website: http://www.fsa.gov.uk.

Mortgage regulation focuses also on advertising requirements, requiring mortgage adverts to be balanced, clear, fair and not misleading. The FSA has set various rules with which firms selling these types of plans need to comply with when issuing adverts about their products.

Another key requirement is for lifetime mortgage providers to assess the suitability of these products for the individual. Also, authorised firms are expected to train their staff properly and ensure that they have proper internal controls in place for monitoring the sales activities. These products are not reversible and in the majority of cases involve the major asset of an elderly individual who may not necessarily be in a position to assess all the implications involved on his/her own, particularly if subjected to aggressive sales techniques. There are various aspects one needs to consider and hence the provision of adequate advice is essential.
Senior management is also expected to take responsibility for the product design and marketing process.

Moreover, through regulation, if lifetime mortgage providers do not follow the conduct of sale rules and something goes wrong, the borrower will have a right to seek redress. The FSA is also developing a consumer educational campaign about these type of products.

04.2.2 Home Reversion Plans

The FSA is also responsible for the regulation of home reversion plans. Regulation of these products came into force on the 6th April, 2007. This legislation is similar to other forms of legislation which regulates: [i] lifetime mortgages; and [ii] conventional mortgages for home purchase plans. The new rules are included in the Mortgages and Home Finance: Conduct of Business ("*MCOB*") Sourcebook which are contained in the FSA's handbook. The regulatory regime consists of eleven "high-level" conduct of business principles, which apply to all financial transactions within the FSA's jurisdiction.[83] The MCOB include matters such as advertising and promotion (MCOB 3), responsible lending (MCOB 11), and charges (MCOB 12) applicable to all regulated mortgage and home finance products. Furthermore, the MCOB adapt the FSA's rules on disclosure requirements (MCOB 9) and the provision of advice on such products (MCOB 8) to the particular circumstances of equity release contracts.

The FSA's authority to regulate equity release schemes stems from the Financial Services and Markets Act, 2000 as amended by the Regulation of Financial Services (Land Transactions) Act, 2005. Any person who provides, administers, arranges for or advises on equity release schemes must be authorised or apply from exemption from authorisation. Authorisation requires the firm to meet a number of conduct of business obligations and prudential supervisory requirements listed in the UK legislation. Intermediaries selling such products require authorisation by the FSA and are bound by a code of conduct. The FSA has detailed conduct of business rules which ensure consumer protection. Such rules *inter alia* rules on: [i] advertising; [ii] client profile requirements; [iii] the form and content and timing of information and disclosure to clients or potential clients prior to entering into a contract; and [iv] a complaints procedure for consumers of equity release products.

The FSA enacted legislation to regulate home reversion plans to ensure that:

- firms offering these products must be fit and proper and appropriately resourced with staff competent to undertake this business;
- consumers will get clear, concise and consistent information about a firm's services and products on offer (including appropriate risk warnings) so they can make informed choices;
- consumers will get good quality advice and be sold suitable products which take account of their circumstances and needs; and

[83] The eleven principles, which the FSA describes as "the fundamental obligations of all firms under the regulatory system" are published in the FSA's Principles for Business Handbook (PRIN), available at: http://fsahandbook.info/FSA/html/handbook/PRIN/2/1.

- if things go wrong, consumers are able to obtain redress, if appropriate.[84]

Moreover, the consultation document issued by the FSA in April 2006 stated that the main concern for regulating home reversion and home purchase plans was to ensure protection of consumers which according to the FSA are subject to the following potential risks:

- *potentially vulnerable consumers*: home reversions are primarily intended for older and potentially vulnerable consumers;
- *mis-buying*: consumers may not appreciate the adverse implications of taking out a home reversion plan;
- *mis-selling*: consumers may be advised to take out a home reversion where an alternative means of raising the required funding would have been preferable;
- *need for legal advice*: consumers may not appreciate the importance of obtaining professional legal advice before entering a home reversion contract;
- *fair valuations*: consumers may not receive a fair price for their property as a result of an unreasonably low valuation;
- *rights as tenant*: consumers could be disadvantaged if the provider fails to exercise its rights as 'landlord' fairly through the life of the plan; and
- *security of tenure*: consumers may also be at risk of losing their security of tenure or in the case of partial reversion, their residual interest in the property, if the provider sells their house to a third party or becomes insolvent.[85]

[84] Green light for new home finance regulation; [Online] The new rules are included in the Mortgages and Home Finance: Conduct of Business Sourcebook which are contained in the FSA's handbook.
[85] Regulation of Home Reversion and Home Purchase Plans pg. 17.

05. Equity Release Products: The Local Scenario

05.1 Introduction

This section of the Report explores whether there is a market for equity release products in Malta.

05.2 Development of Equity Release Products Market in Malta

According to a survey on Perceptions on Retirement and Pensions, carried out by the National Statistics Office in 2005, only 1.5% of the respondents at the time saw property as a possible source of retirement income. As illustrated in Table 11, out of the total respondents, only those aged between the ages of 25 and 54 attributed property as a potential source of income for their retirement. Respondents aged between 18 to 24 and 55 to 64 did not link property to retirement income.

A possible cause could be that it is generally the norm that people aged between 18 and 24 do not own their own property. Moreover, the older age group may be attached to their property and therefore may be reluctant to convert their property into retirement income. There could be various other reasons why this age group did not consider property as a potential source of retirement income. However although the question in the survey did not specifically refer to release of property for equity release purpose but rather to the sale of property for retirement, and the survey did not distinguish between the sale of the main or second property, these statistics may hypothetically indicate the beginning of a culture change as to how some home owners view their property and how much they are attached to their property. It would be insightful if an update of this survey is carried out in order to reassess the perceptions and associations of people as a possible indicator of potential demand for equity release products.

Table 11: Distribution of potential pensioners by possible main sources of income on retirement and by age group.

Possible Sources of Income on Retirement	***Ages***								***Total***	
	18 - 24		***25 - 34***		***35 - 54***		***55 - 64***			
	No.	***%***	***No.***	***%***	***No.***	***%***	***No.***	***%***	***No.***	***%***
Government Pension	18	32.10%	18	40.90%	67	79.80%	14	93.30%	117	58.80%
Private Pension	15	26.80%	13	29.50%	7	8.30%	0	0.00%	35	17.60%
Interest and/or other investment income	7	12.50%	6	13.60%	3	3.60%	0	0.00%	16	8.00%
Income from part time work	5	8.90%	2	4.50%	1	1.20%	0	0.00%	8	4.00%
Income from sale of property	0	0.00%	2	4.50%	1	1.20%	0	0.00%	3	1.50%
Do not know	11	19.60%	3	6.80%	5	6.00%	1	6.70%	20	10.10%
Total	56	100.00%	44	100.00%	84	100.00%	15	100.00%	199	100.00%

Source: Perceptions on retirement and pensions, 2005, National Statistics Office

Equity release plans may prove to be attractive in view of the demographic changes to the population. Statistics from the Census of the Maltese population carried out in 2005 indicated that in November 2005, the average age of the population stood at 38.5 years, when compared to 35.7 years in 1995 and 33.8 in 1985. Moreover, there was a marked decline in the number of persons less than 15 years resulting from a declining fertility rate. The number of people aged 0 to 14 years totalled 69,486, or 16.1 per cent less than in 1995 and there was a significant increase among the older age groups. The 50 to 64 age group increased by 42.5 per cent in the 10 years since 1995 while the 65 and over age group grew by 28.6 per cent to stand at 55,671 persons.[86] Statistics from the census carried out in 1995 and 2005 indicate an increase in the number of single person households, where the number of single person households out of total households increased from 14.8% in 1995 to 18.9% in 2005.

Figures from the census carried out in 2005, appear to follow the results of the Structure Plan for the Maltese Islands (2002), which indicate that the number of single person households in Malta is increasing. The Structure Plan attributes this growth in single person households to increases in: [i] the number of young married couples remaining childless; [ii] mature persons living independently; [iii] single parent households; and [iv] returned migrants. Moreover the number of single person households is expected to increase by 2020. It is hypothesised that the main increase in this population category will arise from the growing number of such households between the ages of 20 and 40, as well as a rise of 10 per year in single male (aged 25 – 30) households, amongst other reasons.[87]

These demographic changes in households and the population, coupled with a high home-ownership percentage, and possibly a culture change towards property, may lead to the emergence of equity release markets in due course. Although no data and official information is available, it appears that there are some incentives already available on the market related to care arrangements for elderly couples which involve some form of use of property equity by the elderly individuals. However, as already indicated detailed research would need to be carried out to assess the impact of such changes on developing the equity release products market in Malta.

05.3 Equity Release Products: Impact on the Maltese Legislation

In Malta, there is no legal framework which provides for the regulation of equity release products. This notwithstanding, it should be noted that legislation regulating the operations of credit and financial institutions already regulate the provision of loans to the public.

In this regard, if the equity release market is to be developed in Malta a cost benefit analysis of the introduction of this regulatory regime should ideally be carried out in comparison with potential demand for Equity Release Products. Further research on the implementation of a proper regulatory regime to ensure: [i] proper conduct of business by entities providing these products; and [ii] adequate protection of consumers should also be carried out.

The tax implications of equity release products would also need to be considered. In addition, the impact of such products on property legislation in particular to laws relating to inheritance would also need to be assessed. Moreover there may also be scope for these type of plans to be assessed from a property / housing policy perspective – particularly in home reversion plans where product providers as well as consumers would be actually taking a position on the property market.

[86] Census of the Maltese Population 2005.
[87] Housing Topic Paper (2004) pg. 22 – 23.

06. Recommendations and Way Forward

The purpose of this Paper was to analyse the changes in the social, economic and demographic scenarios since the publication of the 2005 Property Paper, and to reassess the validity of the recommendations of the 2005 Property Paper in terms of the current scenario.

Findings from this Paper concur with the recommendation of the 2005 Property Paper that property should not be seen as a substitute source of retirement income to Second and Third Pillar pensions – but rather as a complement thereto, since there could be a section of the population which could consider property as an optional source of income under the Third Pillar Pension.

However, the question is whether there is scope to actively / formally propose the development of such a market, and if so whether it should be regulated.

It is recommended that these questions can only be answered following first and foremost the undertaking of further research on the savings pattern of the Maltese population with the aim of: [i] identifying Malta's savings ratio; and [ii] the portion of an individual's wealth which is invested in property and the spread thereof among the population; and [iii] determining any existing arrangements which contain elements of equity release schemes.

It is also suggested that this research should be complemented with an impact assessment on the take up of such products by the Maltese population. This impact assessment could *inter alia* analyse: [i] the impact of the Maltese traits and perceptions on giving up their property for future income; [ii] the cost of an awareness and educative campaign aimed at introducing such products in Malta; and [iii] the negative impact of adverse fluctuations in property prices which could have on consumers of such products. Moreover, the impact assessment would also need to incorporate any trends in the rental market, which might be brought about by the rent reform.

The taxation and inheritance aspects would also need to be looked into.

Lastly, if demand for Equity Release products results, it is recommended that further research is carried out regarding the need or otherwise of a regulatory regime for such plans. The introduction of legislation in this area should be accompanied by a cost benefit analysis especially if research shows that there will be a limited market in such products.

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