



Pension Reform

Proposals

By

The Malta Institute of Management

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Introduction

As has been persistently argued over and over again, given the changes in the country's demography and labour force composition, there is a growing need to pay attention to the adequacy and sustainability of our pensions system. The Working Group set up by government has sought to do just that. In fact the White Paper that this group has produced is a document that:

1. Illustrates the challenges that the current pensions system is expected to face in the near future.

And

2. Makes a number of recommendations to address these challenges in a socially responsible way that is both adequate and sustainable.

The Working Group's main recommendations regard the modification and amelioration of the First Pillar and the introduction of a three Pillar Pension regimes. To this end, this paper seeks to establish the suitability or otherwise of models already in existence in other countries, and also to define the best way of putting the recommended reforms into operation in a way that complements and enhances, but does not substitute, the current pensions regime.

In view of the importance of the pensions issue the Malta Institute of Management (henceforth referred to as MIM) is taking this opportunity to proffer its contribution towards this debate in the hope that the aim of transforming the present pensions system into a more adequate and sustainable one is actually achieved.

The First Pillar

Looking back one immediately realizes that the First Pillar or Public Pensions Scheme has since its inception sustained very little changes. In fact, it has been common belief for quite some years now that the Public Pension Scheme needs a revamp that rectifies in particular the discriminatory practices that make this First Pillar so unattractive to certain sections of the Maltese work force. The MIM is of the opinion that the government:

1. Should redress the disadvantages in the way that pensions are calculated especially with regard to the self-employed.
2. Should review the contribution schemes that exist with respect to part timers and casual employees. The current system does not assist managers in planning employment when it comes to part timers and casuals in view of the effect that the current SSC system has. Government has introduced new employment legislation to eliminate discrimination between full timers and part timers but it has fallen short in adjusting the anomalies that exist in the SSC in due time.

And

3. Furthermore the MIM believes that the level of contribution should not be capped as it is in the current system. However, the removal of such capping should be planned and introduced gradually in view of the effect it will have on disposable income as well as on costs and cash flow.

Apart from these suggestions the MIM is of the belief that:

1. Retirement should not be tied to the age of a person but rather to the number of years of contribution that he or she has paid.

And

2. Providing that the economic climate is favorable, that is, able to sustain such an initiative without jeopardizing the employment of young people, experienced managers should be encouraged to continue working beyond their retirement age.

This would ensure that the experience gained by these veterans is not lost because of retirement.

The Second Pillar

The White Paper claims that the objective of introducing a second pillar pension regime is to ensure the suitability of income at old age. In fact quoting the said White Paper, ‘as inflation gradually erodes the value of today’s pensions, the danger of pensioners experiencing reduced purchasing power and a concomitant reduced standard of living becomes a stark reality’. Therefore the aim of a second pillar pension regime is that of topping up the first pillar with a pension, the extent of which, would, by and large, be based either on:

(a) the contributions paid by the employer and the employee, and the return on investment derived, throughout the period during which a person is in employment and contributions are being made [defined contribution scheme (DCS)]; or

(b) the pre-determined amount of benefit agreed between the contributors and the administrators of the pension at inception[defined benefit scheme (DBS)].

Given the number of cases of occupational pension deficits in other countries (situations where the amounts due to present and future pensioners are more than the assets owned by the pension scheme) it is being assumed that second and third pillar pensions will be constituted as DCSs and not as DBSs.

Second Pillar – Which Option?

The Second Pillar Pensions regime refers to Pensions Schemes that are invested in funds with the aim of augmenting the pension that every contributor is entitled to under the First Pillar, and thus ensure the suitability of income at old age. According to the White Paper, there are two ways of implementing this type of regime. One can adopt either:

1. Privately managed Occupational Schemes and Funds constituted and regulated under the Special Funds (Regulation) Act (SFA). This regime could be complemented by a Compensation Scheme, the main purpose of which would be to mitigate fraud and misappropriation;

Or

2. A pension Scheme that is totally administered by the Government under the supervision of a Board of Trustees that includes the social partners. Given the size of Malta this option would minimize the cost of administration of the SPPS and benefit from economies of scale. This option has been criticized as *denuding the opportunities for competition that a free market renders*.

With regard to the two options mentioned above the White Paper seems to support the idea that occupational pensions should be serviced by the Private Sector. In fact the White Paper dedicates a lot of analysis to this approach. Despite this in depth analysis however, the Working Group failed to consider, and in some particular instances even played down, some very important factors. In particular, it did not consider the administrative expenses and burdens associated with these structures and the risks run by employers in times of poor cash flow.

Administrative expenses and burdens associated with Occupational Scheme and Fund structures

The proposed framework for the provision of occupational pension schemes under the SFA revolves round the setting up of Retirement Schemes the income of which is invested in Retirement Funds. Such Retirement Schemes and Funds are provided with services by a number of service providers including:

Retirement Scheme Administrators;

Retirement Fund Administrators;

Asset Managers (may be required at the level of both the RSA and the RFA);

Actuaries;

Auditors;
Legal Advisors and
Custodians (when applicable).

Obviously there are other charges which would be incurred by Retirement Schemes / Retirement Funds, these could include Directors Emoluments and so on and so forth.

Fees/charges levied to Retirement Schemes and Retirement Funds will ultimately be paid from the assets of the said Schemes/Funds which will be made up of the contributions intended to benefit future pensioners. Therefore, the amounts paid in charges and fees will ultimately be incurred by the future pensioner. In fact whether or not the said Schemes/ Funds make a profit or a loss on their investments the above-mentioned service providers would normally be entitled to a fee.

The more the fragmentation in this sector, [ie: the more the different Retirement Schemes offered to the public and the more Retirement Funds available to Retirement Schemes]:

(a) the more the services of the above mentioned service providers will be required and the greater the overall expense which (globally throughout Malta) will be incurred by the future pensioner. Moreover, given the size of the Maltese working population, the more the private schemes and funds, the more the expense per capita.

(b) the more the administrative burden for employers who will have to deal with a lot of different scheme providers. Until today employees had no say in the choice of the provider, the only provider being the State, but if the private sector approach is adopted in the manner prescribed in the White Paper, wherein employees will be given the right to choose which Scheme to subscribe to, employers would have to transact with a lot of different scheme providers. This situation will affect all employers, but most particularly, small businesses. It is a known fact that small businesses rely on service providers with respect to administrative work. In such a scenario, with the increased

administrative burden these will have to rely even more on administrative service providers and hence incur added costs.

MIM Opinion

Given that:

(a) if the private sector approach is chosen, a good number of present financial services providers (including the two big banks and the big insurance companies) will probably be prepared to enter this market, the second pillar regime would most probably be characterised by an Oligopoly type of fragmentation; and hence a lack of the type of competition which would give rise to a reduction in costs;

(b) under the structure afforded by the SFA for the provision of private occupational pensions, the assets which are available for future pensioners will be partly eroded by the various fees/charges which the Retirement Schemes and the Retirement Funds will have to pay to service providers;

The Malta Institute of Management is of the opinion that this option would probably generate more wealth and growth in the field of financial services. However, it does not ensure the suitability of income at old age through an increase in pension income.

Fraud and mismanagement

Other problems which are very much associated with privately managed schemes and funds regard the fraud and/or mismanagement of these same funds or schemes. Cases such as the UK Maxwell case indicate that privately managed schemes and funds are very susceptible to fraud and/or mismanagement. What is more alarming however is the fact that notwithstanding all the protections afforded by the SFA and the compensation schemes proposed the risk of fraud and mismanagement will never be completely

dispelled, or for that matter, compensated for. Compensation schemes, in particular, are usually ¹capped and therefore the investors would never be compensated for the full amount lost.

Cash flow

The increased levels of contributions might lead to further cash flow problems to employers. All businesses but particularly micro businesses will have to rely even more on their cash flow management skills. Nonetheless, it is a known fact that most businesses in their life face cash flow problems at one point or another.

In a scenario where a business is having cash flow problems and finds itself in no other position but to delay payments:

(a) under the current system, the employer would be called upon by the Social Security Department (SSD). Furthermore, when the employer has delayed payment, the employee, under today's system, is still guaranteed a pension as the presentation of an FS3 will suffice the SSD.

(b) in a Private Schemes scenario and in accordance with article 34 of SFA, the employer would have to face action from various scheme providers. In a cash flow problem scenario such action from various parties may lead to the closure of business with the consequences that this brings with it. Moreover, present available information does not clarify whether in such a situation the employee would still be warranted a pension or whether such employee would have to suffer a no receipt no pay situation.

Drawing on the analysis set forth above the MIM is of the opinion that Private Occupational Schemes and Funds do not offer a reassuring solution to the problem of pension reform. Actually they can constitute a risk both to the people and entities

¹ For example, Compensation under the Investor Compensation Scheme is capped up to a sum of Euro 20,000- regulation 17 of the Investor Compensation Scheme Regulations L.N. 368 of 2003 refers.

involved and to the economic, political and social fabric of our society. In view of the important social role which pensions play in our society, and in view of the fact that in crisis situations, affecting utility sectors and involving important issues, the government is always called upon to step in and remedy the situation, the MIM is of the opinion that the problem posed by the Second Pillar Pensions Scheme can only be solved through the creation of a Private-Public Partnership arrangement.

The Private-Public Partnership solution

The Private-Public partnership solution is defined as being a Second Pillar Pensions Scheme where the Government, together with the Social Partners, acts as the trustee/administrator, with the management of the Scheme awarded by means of competitive tender to a single private firm or to an institution such as the Central Bank of Malta (CBM).

In this regard the MIM proposes that the Government by way of an act of Parliament establishes an Occupational Pensions Scheme (OCPS) Act, which would:

1. Provide for the setting up of an independent Public Authority that is accountable to Parliament. This Authority should be empowered to act on behalf of the Government and the Social Partners as an Administrator and a Trustee of the Occupational Pension Scheme.
2. Give the said Public Authority the necessary powers to appoint an ²institution to manage the assets of the Occupational Pension Scheme (OPS) in accordance with the prudent person principle, as defined in the White Paper, and to redirect any profits made back into the scheme.

² This institution could be either a private one, or else, the Central Bank of Malta, in which case the overall cost to the Occupational Pension Scheme would be further reduced.

3. Ensure that the assets of the OPS are properly safeguarded through ³regulatory standards specifically drawn up for this purpose.
4. Ensure that both the Scheme and Asset Manager (as long as this is not the CBM) are properly supervised. This supervision can be accomplished by subjecting the aforementioned entities to regulatory standards, and to a minimum amount of supervision, by the Malta Financial Services Authority (MFSA). In this regard the MFSA could be provided with the required powers by the OCPS Act.
5. Ensure that the overall costs of administering the OPS are kept to the bare minimum, and that the annual budget of the Scheme and the Public Authority would be subject to review and endorsement by Parliament. The Ministry of Finance would monitor compliance with the said budget.
6. Require both the OPS and Public Authority to submit annual financial statements prepared in accordance with internationally accepted standards and have the annual (that is end of year), financial statements reviewed by third party auditors.
7. Require that all Maltese employers and employees contribute to the Scheme, and that the Public Authority would on the retirement of a contributor purchase, on behalf of the said contributor now turned pensioner, an annuity to ensure a regular income for the remainder of his/her life.
8. Establish this Second Pillar on a voluntary basis. In order to encourage such schemes Government should provide tax incentives of for example a deductible tax allowance of 200 percent of the cost. Furthermore, the capping of contributions and benefits in the first pillar should be gradually phased out. It is imperative that in removing such capping Government takes into account
 - The economic circumstances
 - The cash flow implications
 - The added cost for employersAnd
 - The reduction of disposable income.

³ Reference can be made to local standards which for a number of years have been applied in other areas of financial services, such as the Investment Services Act (Control of assets) Regulations 1998, [L.N. 240 of 1998]

The Private-Public Partnership pension arrangement as described above, unlike the aforementioned private sector arrangement, makes for a safer, simpler, and therefore cheaper, option for all those having an interest in the way that the Second Pillar is run. The protections offered by this particular arrangement are a guarantee to contributors, employers and Government alike that:

1. The resources used in the administration of the said Scheme and Authority are managed in the most efficient and effective manner.
2. The amount of administrative expenses and burdens are kept to the bare minimum.

And that

3. These checks and balances warrant a significant reduction in the risk of fraud and mismanagement. In fact this system presents in itself an assurance that Government will be more in a position to assess, and thus control, the economic and social impact of taking certain action/s, when compared to a private entity whose only interest is the bottom line.

Conclusion

It is very clear that the current pensions system is neither adequate nor sustainable to meet the challenges that are expected to arise in the future. The MIM is of the belief that Malta is still on time to analyse the impact of all the options proposed on the economy, society and health, and identify an appropriate time whereby the impact of these changes will be reduced as far as possible. Malta should not take measures in a rushed manner which could result to be inefficient or harmful in the long run.

The Malta Institute of Management contends that Malta is still on time to plan and manage the needed changes in an adequate and efficient manner.

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