

The Pensions Working Group

Research Report

Final Report of the Pensions Working Group, July 2005

Pensions Strategy Group (Malta) Research Series

Provided in Cooperation with:

Central Bank of Malta, Valletta

Suggested Citation: The Pensions Working Group (2005) : Final Report of the Pensions Working Group, July 2005, Pensions Strategy Group (Malta) Research Series, Central Bank of Malta, Valletta

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Executive Summary

The Pensions Working Group, following the launch of the White Paper on Pensions reform tabled by the Prime Minister in the House of Representatives on 24th November 2004, carried out an extensive and embracing national consultation and discussion process where-in it held 39 sessions with various stakeholders and 17 sessions with the media. The Group received 47 formal submissions following the closure of the consultation and discussion process at the end of April 2005.

During the period of the consultation and discussion process the Group continued with its work and four major studies were carried out. These are the Economic Impact Assessment, the Social Impact Assessment, the Actuaries Assessment, and the Survey on people's perceptions on the pensions system and pensions reform. This work was placed in the public domain following a Press Conference which the Group held on 23rd April 2005.

It is pertinent to underline that the feedback received was unanimous in the fundamental conclusion that an option of 'no reform' to the current pensions system is not a solution. This conclusion confirms the Group's position as stated in the White Paper that a reform of the pensions system is a paramount necessity if pensions for future generations are to be both adequate and sustainable.

It also should be stated that the feedback received agreed that the White Paper was a good basis upon which mature discussion could be carried out on the reforms necessary to attain an adequate and sustainable pensions system. As expected, the feedback received was at times in agreement, in part or in whole, and at times in disagreement, in part or in whole, with the recommendations presented in the White Paper.

In summary, the primary concerns raised in the feedback are:

01. **Maximum Pension Income:** The general position is that the Maximum Pension Income of Lm6,750 introduced in 1981 is no longer adequate and must be changed. Various ways of how this should be achieved are proposed.
02. **Pension Indexation to Wages:** The general position is that a strict indexation with inflation would result in a state of play where the Two-Thirds Pension would become a flat pension as most people will, over the period under review, earn beyond the Maximum Pension Income ceiling. This would result from the fact that, generally, wage increases tend to outstrip inflation.
03. **Increase in Statutory Retirement Age:** Most feedback agrees, with the exception of a number of unions, that the retirement age should increase to 65 years. Nevertheless, concerns were raised on the fact that particular jobs, mainly those related to manual workers, due to their intrinsic nature cannot be carried out by persons who are past a certain age.
04. **Changes to the Accumulation and Calculation Parameters of the Two-Thirds Pension:** These recommendations were received negatively. The main concern is directed to the proposal of departing from final salary calculation to linking the calculation of the pension with the contributions paid over one's accumulation period. The general consensus is that this recommendation will severely impact the adequacy of one's pensions.
05. **Private Pensions:** Whilst there is unanimous agreement to the introduction of Second Pillar Pensions on a voluntary basis the general position is not in favour a mandatory introduction.
06. **Channelling of Pensions Contributions to the Health Fund:** Whilst there is unanimous agreement that health reform is necessary the general position is that pension contributions should be directed for the purpose they are collected: pensions.

The Group, with the support of its Technical Team, has now studied, assessed and evaluated its original recommendations as presented in the White Paper in light of the feedback received and further studies carried out by the Group.

The Group in carrying out its post-consultation work simulated various models of reform scenarios. In finalising its work the Group was motivated by one fundamental principle: that of securing a measured solution that balances adequacy and sustainability upon which consensus for the reform to the pensions system can be built.

The reform of a pensions system, as amply demonstrated during the consultation process, is a sensitive matter and, above all, a personal one: the views for reform of an entrant to the labour market are different from those of a pensioner; those of a person in the middle of a career are different from those of one who is set to retire; the views of a manual worker are different from those of a non-manual worker - and there is not always conformity amongst non-manual workers.

A measured and balanced solution to pensions reform, however, demands trade-offs between various policy instruments that affect people impacted by any reforms to a pensions system differently. A measured and balanced solution, therefore, demands compromise from all stakeholders.

It is pertinent to underline that in presenting the recommendations in this Report, the Group on the basis of the feedback received, its continued work, and the results of the simulations carried out reconsidered its position on a number of the original recommendations put forward.

The Group presents its final work in the form of a Final Report and 7 Supplementary Papers. The following are the final recommendations of the Group as compared to its original recommendations in the White Paper:

| Original Recommendations | | Final Recommendations | |
|--------------------------|--|-----------------------|---|
| 01. | Government should positively consider issuing the Report of the Pensions Working Group as a White Paper to facilitate the national discussion and consultation process required on this important matter. | 01. | The Pensions Working Group recommends that the Government should positively consider placing the Final Report and the accompanying supplementary papers in the public domain to further contribute to the mature debate that has taken place to date on this sensitive issue. |
| | | 02. | The Pensions Working Group recommends that there should be no changes to the parameters enjoyed by pensioners or persons who would have retired by the time the proposed reform to the pensions system is embarked up on. |
| 02. | Whilst the process of pensions reform must be holistic in its design and formulation, implementation of measures constituting the new pensions system should, as far as possible, be staggered and phased. | 03. | The Pensions Working Group recommends that the process of reform must be a journey with measures introduced incrementally and in a phased manner, differentiating in varying degrees, as and where necessary, between three age cohorts: (a) the Exempted group; (b) the Transitional group; and (c) the Switchers group. |
| | | 04. | The Pensions Working Groups recommends that the reformed pensions system must be calibrated by means of a Five Year Structured Review to reflect arising opportunities and challenges stemming from the macro-economic performance and behaviour of Malta over time. |
| 03. | There should be a minimum pension guarantee that acts as a safety-net against social exclusion. | 05. | The Pensions Working Group reaffirms its recommendation to establish a Minimum Pension Guarantee which is established at approximately 50% of the average wage - Lm2,421. |

| Original Recommendations | | Final Recommendations | |
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| 04. | A fair mechanism needs to be put in place to automatically assure the value of the minimum pension guarantee against inflation. | 06. | The Pensions Working Group recommends that the Minimum Pensions Guarantee should be automatically indexed to a mechanism that is constituted of 70% wages and 30% inflation. Moreover, the ceiling should be subject to a Control Lever that may be applied following the Five Year Structured Review that could result to an increase of the Guarantee Ceiling by the Average % of Wage Increases occurring between one Five Year Structured Review and the other. Application of this increase to the Guarantee Ceiling would be subject to the performance of the economy and public finances. |
| | | 07. | The Pensions Working Group recommends that credits to a person's pension contributions as established in the Social Security Act (Chapter 318) should continue to be maintained. |
| 05. | The new pensions system must be supported by a strong compliance regime to safeguard honest and hard working persons as well as to deter abuse, fraud and mis-use. | 08. | The Pensions Working Group recommends that the Anti-Fraud Unit of the Department for Social Security should seek synergies and information sharing with the Tax Compliance Unit of the Ministry of Finance so that a holistic approach towards clamping down on abuse, misuse and free-riders is adopted. |
| 25. | The Two-Thirds Pension must remain as the main mechanism to ensure solidarity. Participation in the Two-Thirds Pension is to continue to be mandatory. | 09. | The Pensions Working Group reaffirms this recommendation. |
| 26. | Solidarity within generations requires that the First Pillar post-retirement pensions income is annually built up for all pensioners on an annual uniform basis. The annual uniform basis to be applied should be the Retail Price Index. | 10. | The Pensions Working Group recommends that the post-retirement pensions income should be automatically indexed to a mechanism that is constituted of 70% wages and 30% inflation. Moreover the ceiling should also be subject to a Control Lever that may be applied following the Five Year Structured Review that could result to an increase of the post-retirement pensions income by the Average % of Wage Increases occurring between one Five Year Structured Review and the other. Application of this increase to the post-retirement pensions income would be subject to the performance of the economy and public finances. |
| 27 | The recommendation of the NCWR to increase the statutory retirement age to 65 years is a positive measure directed to broaden the contribution base as well as to enlarge the pool of labour supply. | 11. | The Pensions Working Group states, in the most unequivocal manner, that a pensions reform that fails to consider the impact of demographic changes will: <ul style="list-style-type: none"> (a) result in mere tinkering of the inevitable collapse of the pensions system; and (b) negatively impact economic growth and output. |
| 28. | The statutory retirement age of 65 years will be for both men and women. | 12 | The Pensions Working Group reaffirms this recommendation. |

| Original Recommendations | | Final Recommendations | | | | | | | | | | | | | | | | | | | | | | | |
|---|---|---|---|------------------------|-----------|--------------------------------|----------|--------------------------------|----------|-------------------------|-----------|-----|--|---|-----------------------|------------------------|-----------|--------------------------------|----------|--------------------------------|----------|------------------------------------|----------|-------------------------|-----------|
| | | 13. | The Pensions Working Group believes that given the differences in average life expectancies between manual and non-manual workers there is merit in retaining the 61 years retirement age for manual workers within the Transitional and Switchers groups respectively on the basis of a light disincentive regime. | | | | | | | | | | | | | | | | | | | | | | |
| | | 14. | The Pensions Working Group believes that there is no legitimate reason for non-manual workers to be excluded from the proposed statutory retirement age, and supporting policies by employers such as redeployment, re-skilling, re-assignment et al, should be introduced to render later working life more attractive. | | | | | | | | | | | | | | | | | | | | | | |
| 29. | <p>The rising of the statutory retirement age to the proposed 65 years should be gradual with women reaching the 61 year threshold in 1st January 2007. Subsequent to which the statutory retirement age is to increase as shown in below:</p> <table border="0"> <thead> <tr> <th>Years of Age as at 1st January 2007</th> <th>Retirement Age</th> </tr> </thead> <tbody> <tr> <td>55 yrs of age and over</td> <td>No Change</td> </tr> <tr> <td>52 yrs of age to 54 yrs of age</td> <td>62 years</td> </tr> <tr> <td>49 yrs of age to 51 yrs of age</td> <td>63 years</td> </tr> <tr> <td>48 yrs of age and below</td> <td>65 years.</td> </tr> </tbody> </table> | Years of Age as at 1st January 2007 | Retirement Age | 55 yrs of age and over | No Change | 52 yrs of age to 54 yrs of age | 62 years | 49 yrs of age to 51 yrs of age | 63 years | 48 yrs of age and below | 65 years. | 15. | <p>The Pensions Working Group recommends that the statutory retirement age for non-manual workers to the proposed 65 years should be gradual with women reaching the 61 year threshold in 1st January 2007. Subsequent to which, the statutory retirement age is to increase as shown below:</p> <table border="0"> <thead> <tr> <th>Years of Age as at 1st January 2007</th> <th>Retirement Age</th> </tr> </thead> <tbody> <tr> <td>55 yrs of age and over</td> <td>No Change</td> </tr> <tr> <td>51 yrs of age to 54 yrs of age</td> <td>62 years</td> </tr> <tr> <td>48 yrs of age to 50 yrs of age</td> <td>63 years</td> </tr> <tr> <td>46 yrs of age and to 47 yrs of age</td> <td>64 years</td> </tr> <tr> <td>45 yrs of age and below</td> <td>65 years.</td> </tr> </tbody> </table> | Years of Age as at 1st January 2007 | Retirement Age | 55 yrs of age and over | No Change | 51 yrs of age to 54 yrs of age | 62 years | 48 yrs of age to 50 yrs of age | 63 years | 46 yrs of age and to 47 yrs of age | 64 years | 45 yrs of age and below | 65 years. |
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| 29. | Individuals should be able to opt for a shorter career between the age of 61 to 65 years on the basis of proportionate benefits. | 16. | The Pensions Working Group recommends that a non-manual worker will have the option to opt out of the labour market between 61 years of age and 65 years of age subject to a heavy disincentive regime that would include a loss of 6% of the full pension entitlement for each year opted out; a freeze on the value of the pension; and a freeze on the post-retirement pension indexation until the statutory retirement age is reached. | | | | | | | | | | | | | | | | | | | | | | |
| | | 17. | The Pensions Working Group proposes that the Government considers introducing an immigration policy that seeks to attract immigrant labour with the skills required to meet gaps in the human stock necessary for Malta's economic growth. | | | | | | | | | | | | | | | | | | | | | | |
| 30. | A person may opt to continue to work beyond the new statutory retirement age, whilst enjoying the Two-Thirds Pension and Second Pillar Pension, with no capping on the income earned, subject to the payment of the Two-Thirds Pension contribution | 18. | The Pensions Working Group reaffirms this recommendation. | | | | | | | | | | | | | | | | | | | | | | |

| Original Recommendations | | Final Recommendations | |
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| | | 19. | The Pensions Working Group recommends that non-manual workers in the Exempt and Transitional groups respectively should be incentivised to work beyond their retirement and earn a combined pensions and earnings income of Lm10,000 subject that the contribution will be paid as an inter-generational solidarity contribution; employment is of a part-time nature; and continued employment in one's job is dependent on the employer's consent. This condition will apply until the person reaches 65 years of age, subsequent to which the proposal in Recommendation 18 will apply. |
| 31. | The current invalidity pensions scheme should be reviewed with a view to tighten the eligibility criteria as well as to adopt the principle of 'rehabilitation or alternative work before pension'. | 20. | The Pensions Working Group reaffirms this recommendation. |
| 40. | The reality of woman's atypical employment and the resultant entitlement handicaps should be recognised and pension policy instruments that reflect this reality are to be introduced. | 21. | The Pensions Working Group reaffirms this recommendation. |
| 41. | A policy instrument that takes into account parental responsibilities in relation to child bearing and child raising periods by providing for the phased crediting of the individual's contributions as well as the payment of voluntary contributions under established conditions should be positively considered. | 22. | The Pensions Working Group recommends that parents should be provided with a two year pension credit for each child born following the introduction of the pensions reform subject to the condition that the parent will return to work for an equivalent time period. Given that costing of this recommendation is not possible through the PROST pension simulation tool, the Group proposes that a final determination by Government should only take place following a cost-benefit assessment of this recommendation. |
| 42. | The introduction of family friendly measures to enable the balance of work and family life and thus ensure not only increased participation but also the retention of women in the labour force should continue to be re-enforced. | 23. | The Pensions Working Group reaffirms this recommendation. A number of recommendations in this regard are presented in the Supplementary Paper titled: Pension Measures to Incentivise Female Participation in the Work Force. |
| 43 | Measures need to be taken to remove those elements in the system that encourage periods of inactivity or activity within the informal economy when people need to be attracted to participate in the labour market even on a part-time basis. | 24. | Whilst the Pensions Working Group believes that should the Minimum National Insurance Contribution be removed the net-effect to the local economy will be a positive one, it recommends that the Government should undertake a cost-benefit assessment prior to a final decision in this regard. |

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| 44. | The design of policy instruments that account for 'credits' for the undertaking of unpaid periods for training, reskilling and continuous development should be positively considered. | 25. | The Pensions Working Group recommends that a person: <ul style="list-style-type: none"> (a) of 30 years of age and above who takes a period between 6 months and 12 months for academic or vocational higher education should have his or her pension credited; and. (b) who follows a Doctorate Degree (PhD) should have his or her pension credited for the first year of study as well as the ability to back-fill the unpaid contributions of the remaining years of study at any point in time prior to his or her retirement, subject to the condition that the contribution paid will equate to the amount due at the time the payment is made. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 32. | The contributions calculation base-line for the Two-Thirds Pension should be retained on the basic salary. The contributions calculation base-line for the Two-Thirds Pension should be retained on the basic salary. | 26. | The Pensions Working Group reaffirms this recommendation. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | 27. | The Pensions Working Group reaffirms the recommendation that the contribution period for the accumulation of the Two-Thirds Pension is increased from 30 years to 40 years. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 33. | The contribution period for the accumulation of the Two-Thirds Pension should be as shown below: <table border="0" style="margin-left: 40px;"> <thead> <tr> <th style="text-align: left;">Years of Age as at 1st January 2007</th> <th style="text-align: left;">Accumulation Period</th> </tr> </thead> <tbody> <tr> <td>46 yrs of age and over</td> <td>No Change</td> </tr> <tr> <td>40 yrs of age to 45 yrs of age</td> <td>35 yrs</td> </tr> <tr> <td>39 yrs of age and below</td> <td>40 yrs.</td> </tr> </tbody> </table> | Years of Age as at 1 st January 2007 | Accumulation Period | 46 yrs of age and over | No Change | 40 yrs of age to 45 yrs of age | 35 yrs | 39 yrs of age and below | 40 yrs. | 28. | The Pensions Working Group recommends that the contribution period for the accumulation of the Two-Thirds Pension should be as shown below: <table border="0" style="margin-left: 40px;"> <thead> <tr> <th style="text-align: left;">Years of Age as at 1st January 2007</th> <th style="text-align: left;">Accumulation Period</th> </tr> </thead> <tbody> <tr> <td>55 yrs of age and over</td> <td>No Change</td> </tr> <tr> <td>54yrs of age</td> <td>31 years</td> </tr> <tr> <td>53 yrs of age</td> <td>32 years</td> </tr> <tr> <td>52 yrs of age</td> <td>33 years</td> </tr> <tr> <td>51 yrs of age</td> <td>34 years</td> </tr> <tr> <td>50 yrs of age</td> <td>35 years</td> </tr> <tr> <td>49 yrs of age</td> <td>36 years</td> </tr> <tr> <td>48 yrs of age</td> <td>37 years</td> </tr> <tr> <td>47 yrs of age</td> <td>38 years</td> </tr> <tr> <td>46 yrs of age</td> <td>39 years</td> </tr> <tr> <td>45 yrs of age</td> <td>40 years.</td> </tr> </tbody> </table> | Years of Age as at 1 st January 2007 | Accumulation Period | 55 yrs of age and over | No Change | 54yrs of age | 31 years | 53 yrs of age | 32 years | 52 yrs of age | 33 years | 51 yrs of age | 34 years | 50 yrs of age | 35 years | 49 yrs of age | 36 years | 48 yrs of age | 37 years | 47 yrs of age | 38 years | 46 yrs of age | 39 years | 45 yrs of age | 40 years. |
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| 45 yrs of age | 40 years. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | 29. | The Pensions Working Group recommends that persons should be allowed to bridge any gaps to meet their respective accumulation periods; subject that payment to reach the accumulation period would be at the contributory rates at the time payment is made. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

| Original Recommendations | | Final Recommendations | |
|--------------------------|--|-----------------------|--|
| 34. | <p>The calculation period of the Two-Thirds Pension should be based on an average of the 40 year contributions accumulation period and introduced as shown below:</p> <p>Years of Age as at 1st January 2007 Calculation Period</p> <p>50 yrs and over No Change 50 yrs to 54 yrs Average of best 5 yrs 45 yrs to 49 yrs Average of best 10 yrs 44 yrs and below 40 years.</p> | 30. | <p>The Pensions Working Group recommends that the calculation period of the Two-Thirds Pension should be on the basis of the average of the best 10 years from the last 20 years. The calculation period should be introduced as shown below:</p> <p>Years of Age as at 1st January 2007 Calculation Period</p> <p>55 yrs and over No Change 50 yrs to 54 yrs Average of best 5 yrs 46 yrs to 49 yrs Average of best 8 yrs 45 yrs and below Average of the best 10 yrs from the last 20 years.</p> |
| 34. | There should be no discrimination between self-employed and employed persons on the time base period upon which a Two-Thirds Pension is calculated. | 31. | The Pensions Working Group reaffirms this recommendation. |
| 36. | The ceiling of the First Pillar's MPI should be the current MPI <i>adjusted yearly to reflect inflation.</i> | 32. | The Pensions Working Group recommends that the Maximum Pension Income ceiling should be set at Lm9,000 as from 1 st January 2007. |
| | | 33. | The Pensions Working Group recommends that the proposed increase in the Maximum Pension Income ceiling will be directed to the Switchers Group. |
| | | 34. | The Pensions Working Group recommends that persons who are in the Exempted and Transitional groups respectively will not be impacted by the proposed increase in the Maximum Pension Income ceiling. |
| 36. | The ceiling of the First Pillar's MPI should be the current MPI <i>adjusted yearly to reflect inflation.</i> | 35. | The Pensions Working Group recommends that the Maximum Pension Income ceiling should be automatically indexed to a mechanism that is constituted of 70% wages and 30% inflation. It will also be subject to a Control Lever that may be applied following a Five Year Structured Review that could result to an increase of the Maximum Pension Income ceiling by the Average % of Wage Increases occurring between one Five Year Structured Review and the other. Application of such an increase to the Maximum Pension Income ceiling would be subject to the performance of the economy and public finances. |
| 36. | The revenue base line for the determination of the Two-Thirds Pension should remain two-thirds of the basic wage. | 36. | The Pensions Working Group reaffirms this recommendation. |

| Original Recommendations | | Final Recommendations | |
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| 36. | The Class I and the Class II contributions should remain unchanged. | 37. | <p>The Pensions Working Group recommends that whilst the Class I and Class II should remain unchanged, contributions should be paid on the basis of the recommendations on the Maximum Pension Income ceiling and its indexation and will be applied as follows:</p> <p>Switcher Group: New Maximum Pension Income ceiling + Annual Indexation Adjustments to ceiling.</p> <p>Transitional Group: Annual Indexation Adjustments to ceiling</p> <p>Exempt Group: Annual Indexation Adjustments to ceiling.</p> |
| | | 38. | The Pensions Working Group recommends that the valorisation mechanism should be on the basis of inflation. |
| 38. | The 2004 budget declaration that health funding should be separated from social security funding and ring-fenced accordingly, and that part of the social security contribution will finance health services should continue to hold. | 39. | <p>The Pensions Working Group recommends that:</p> <p>(a) the White Paper recommendation to channel part of the Two-Thirds Pension contribution to the Health Fund – assumed to constitute 2% of the Employee's contribution and 1% of the State Grant – is reconsidered.</p> <p>(b) The % contribution marked for channelling into the Health Fund in the White Paper is 'carved out' in order to enable the introduction of a mandatory Second Pillar Pension Scheme in a neutral manner.</p> <p>(c) The original decision in the White Paper, that non contributory benefits should not be paid from the pensions' contributions but should be financed through taxation is reaffirmed.</p> |
| 39. | A ring fenced Account for contribution benefits and pensions, with appropriate transparent governance, is established. | 40. | The Pensions Working Group recommends that for strategic and effective management of the pensions system there should be no cross-subsidisation from National Insurance contributions to support the financing of health or other social services; with revenue collected to be placed within a ring-fenced Pensions Account. |

| Original Recommendations | | Final Recommendations | |
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| | | 41. | The Pensions Working Group recommends that an integral part of the pensions reform is a business, administrative and ICT review of the existing pensions structure directed to: (a) secure a lower cost of administration; (b) attain more efficient and effective revenue collection; (c) achieve simplification; and (d) guarantee transparency. |
| 06. | The new pensions system should include a Second Pillar Pensions Scheme (SPPS) to increase one's pension income to enhance the standard of living. | 42. | The Pensions Working Group reaffirms this recommendation. |
| 07. | The new pensions system should also provide for a Third Pillar Pensions Scheme (TPPS) which shall be a voluntary option directed to complement the pensions income. | 43. | The Pensions Working Group reaffirms this recommendation. |
| | | 44. | The Pensions Working Group recommends that the financial services market should offer regulated Property Pension Funds as a Third Pillar product. |
| 08. | The regulation of the Second Pillar and the Third Pillar Pensions Schemes should be entrusted to the MFSA operating under the Special Funds (Regulation) Act 2002. | 45. | The Pensions Working Group reaffirms its recommendation that the regulation and governance of the Second Pillar and the Third Pillar Pension Schemes respectively are entrusted to the Malta Financial Services Authority operating under the Special Funds (Regulations) Act – with amendments to be made where so appropriate to this Act in terms of EU Directive 2003/41/EC and the Social Security Act in terms of Regulations (EEC) No 1408/71 and 574/72. |
| 09. | The Second Pillar Pensions Scheme should be established in terms of a common yet flexible scheme basis. | 46. | Whilst the Pensions Working Group proposes that the Second Pillar Pension Scheme should not be designed around Defined Benefits schemes it recommends that the Malta Financial Services Authority should work with the financial services market to allow for the design of Second Pillar Pension Schemes that will provide most value to the investor with the least risk at the least cost of administration. It further proposes that the consideration put forward in the White Paper for the introduction of a Two-Tier Second Pillar Pension Scheme is positively met as this allows a contributor to personalise his or her scheme beyond the mandatory requirement without the need to opt for a Third Pillar Scheme, and thus incur additional cost. |
| 10. | An employee should have the right to choose the provider of the Second Pillar Pensions Scheme. | 47. | The Pensions Working Group recommends that as a first step the Second Pillar Pension Scheme should be entered into only through occupational pensions schemes. Changes to the Second Pillar Pension Scheme to introduce individual choice should only be embarked upon once the appropriate credibility, trust and maturity of the Scheme is attained. |
| 11. | The Second Pillar Pensions Scheme will also apply to the self-employed. | 48. | The Pensions Working Group reaffirms this recommendation. |

| Original Recommendations | | Final Recommendations | |
|--------------------------|---|-----------------------|---|
| 12. | Entry into the Second Pillar Pensions Scheme provision by private sector insurance firms must be subject to strict entry and performance criteria that must be met at all times. | 49. | The Pensions Working Group recommends that fair competition is the best guarantee to a contributor to a Second Pillar Pension Scheme. There should be open involvement of financial service providers in the Second Pillar Pension Scheme within the parameters of strict and tight entry and performance criteria which must be met at all times. |
| | | 50. | Whilst the Pensions Working Group reaffirms the recommendations made in terms of the criteria for entry and performance it further proposes that (a) strong sound and sustainable financial capital basis is an absolute necessity; and (b) that the criteria for actuarial experts would be considered to be met if such a service is outsourced or contracted out to a Regulator accredited actuarial service provider. |
| 13. | The Second Pillar Pensions Scheme contributions paid by the employer must be strictly separated from the said employer; with the pension fund established as an autonomous 'ring-fenced' asset. | 51. | The Pensions Working Group reaffirms this recommendation. |
| 14. | The Second Pillar Pensions Scheme should be managed on the prudent-person principle together with (a) the inclusion of specified limitations to determine the diversification parameters of the investment portfolio, and (b) restrictions to limit the private sector insurance firm managing the portfolio to invest in its own assets or subsidiaries. | 52. | <p>The Pensions Working Group reaffirms its recommendation that the Second Pillar Pensions Scheme should be managed on the prudent-person principle together with the inclusion of specified limitations to determine the diversification parameters of the investment portfolio which in addition to those already present under the Special Fund (Regulation) Act 2002 should include:</p> <ul style="list-style-type: none"> (a) Limitations on investments in equities to a maximum limit of 35%. (b) Limitations on investments in emerging markets and non-OECD countries to a maximum limit of 30%. (c) Inability to invest directly in immovable property, though investment in publicly traded equity and / or fixed income securities of companies engaged in the real estate such as property management and property financing companies should be permitted. <p>The Group further recommends that the Second Pillar Pension Scheme funds should be invested in those markets that will render the highest return possible to the investor within the constraints of the prudent person principle and the proposed diversification criteria.</p> |
| | | 53. | The Pensions Working Group recommends that the implementation of parameters (a) and (b) proposed in Recommendation No 52 should be introduced in terms of Regulation (EEC) 1408/71 under the regulation of the Malta Financial Services Authority in order to assure Malta's ability to participate internationally in the provision of Second Pillar Pensions Schemes. |

| Original Recommendations | | Final Recommendations | |
|--------------------------|---|-----------------------|---|
| | | 54. | The Pensions Working Group recommends that in relation to investment in overseas 'fund of funds' criteria (a) and (b) proposed in Recommendation No 52 will not apply in so far that the providers of such overseas 'fund of funds' investment are accredited by the Malta Financial Services Authority. |
| 15. | Measures to provide for financial protection to Second Pillar Pensions Scheme contributors and pensioners against fraud, mis-use, insolvency, etc, must be introduced, and should be designed in a manner that place the least burden on stakeholders. | 55. | The Pensions Working Group reaffirms this recommendation and further proposes that the Government tasks the Malta Financial Services Authority to draw up the protection mechanisms and safeguards that should be introduced in tandem with the launch of the Second Pillar Pension Scheme. |
| 16. | Funds under the Second Pillar Pensions Scheme should be portable and a person should not have the option to liquidate the fund. | 56. | The Pensions Working Group reaffirms this recommendation. |
| 17. | The annual contributions into a Second Pillar Pensions Scheme should not be taxed on an annual basis. A maximum tax, established at a fixed percentage rate, should be paid upon the maturity of the Scheme. | 57. | Whilst the Pensions Working Group supports the economic argument that increased savings have a positive impact on the aggregate wealth of the nation and thus Government should provide fiscal incentives on the Second Pillar Scheme, it recommends that the Government should not make any decisions on the incentives to be adopted until the Supplementary Paper on this matter is presented. |
| 24. | The annual contribution to the Third Pillar Pensions Scheme should be non-taxed up to a capped limit. The income derived on the maturity of the Third Pillar Pensions Scheme will be subject to income tax based on the individual's PAYE rate. | 58. | Whilst the Pensions Working Group believes that incentives should incorporate voluntary Second Pillar and Third Pillar pension schemes respectively, it recommends that the Government should not make any decisions on the incentives to be adopted until the Supplementary Paper on this matter is presented. |
| 18. | The Second Pillar Pensions Scheme should upon maturity allow for the option to convert a maximum established part of the individual matured pension fund into a lump sum and with the bulk placed as an annuity to provide for a steady annual pension income over the lifetime of the pensioner. | 59. | The Pensions Working Group recommends that 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 as a monthly annuity. |
| 19. | The Second Pillar Pensions Scheme should be introduced on a mandatory basis. | 60. | The Pensions Working Group recommends that the Second Pillar Pension is initially introduced in a neutral manner and subsequently phased incrementally. |
| 21. | The Second Pillar Pensions Scheme should be introduced in a transitional manner; with the SPPS to be first introduced on a voluntary basis as from 1 st January 2006. | 61. | The Pensions Working Group recommends that the neutral introduction of a mandatory Second Pillar Pension Scheme proposed in Recommendation 60 is achieved by 'carving out' 1% Employer and 1% Employee from the Class I contribution and a 1% Self-Employed from the Class II contribution respectively into the Second Pillar Pension Scheme as from 1 st January 2007. |

| Original Recommendations | | Final Recommendations | |
|--------------------------|---|-----------------------|--|
| | | 62. | The Pensions Working Group recommends that whilst voluntary Second Pillar Pension Schemes should be introduced as early as possible in 2006 these should be designed in a manner that will allow investors to integrate such schemes in the mandatory Second Pillar Pension Scheme at no administrative cost and without complexities should Government decide in the future to increase the mandatory contribution to the Second Pillar Pension Scheme beyond the proposed 'carve out' contribution. |
| 23. | Indications are that a mandatory Second Pillar Pensions Scheme should be in place by 2010. Government should take all necessary action to establish the appropriate mechanisms to enable the introduction of the Second Pillar Pensions Scheme by 2010. Nevertheless, the Government should in 2009 undertake an assessment to determine whether the prevailing conditions at that point in time are such that necessitate the mandatory introduction of the Second Pillar by 2010. | 63. | The modelling carried out by the Pensions Working Group shows that on the basis of the macro-economic assumptions taken the mandatory contribution to the Second Pillar Pension should increase to 4% by employers and employees respectively by 2025. The Group recommends that a conclusive decision on the quantum, the timing of initiating the increase over and above the proposed 'carve out' contribution, and the phasing of the said increase should take place only following the carrying out of the periodic Five Year Structured Reviews. |
| | | 64. | The Pensions Working Group recommends that a Maximum Salary Limit of Lm15,000 is established as the ceiling for mandatory contributions to the Second Pillar Pension Scheme subject that this ceiling does not apply for the proposed contribution carve out from Class I and Class II contributions; with indexation to be similar to that adopted for the Maximum Pension Income ceiling. |
| 20. | MFSA and Government will work with private sector financial firms to encourage them to introduce a scheme that allows owners of life endowment and profits related policies to convert such policies into the SPPS. | 65. | The Pensions Working Group reaffirms its recommendation that holders of life endowment policies or unit-linked policies that are subject to annual premiums should be provided with the option to lock such policies for pension purposes with the premium paid meeting part or all of their mandatory contributions to the Second Pillar Pension Scheme subject to the condition that upon maturity the funds are transferred to the Scheme. |
| | | 66. | The Pensions Working Group reaffirms its recommendation that the introduction of the mandatory Second Pillar Pension Scheme as proposed earlier in this Report should be applicable for the Switchers group; with people over 46 years of age to be provided the opportunity to opt in subject to no opt out. |

The Group in the recommendations proposed in this Report seeks to achieve the following goals:

- Strengthen the adequacy level of the Two-Thirds Pension and in doing so ensure that this pension pillar remains as the central component of the pensions system.
- Complement the adequacy level of the Two-Thirds Pension through the introduction of a mandatory Second Pillar Pension.
- Secure the adequacy of the pensions system on a financial sustainable basis.

The proposed pensions system presented in this report compares to a 'White Paper Reform' and to a 'No Reform' scenarios respectively as shown below:

| Average Replacement Rate in % points | | | | | | | | | | | |
|---|------|------|------|------|------|------|------|------|------|------|------|
| | 2007 | 2013 | 2015 | 2020 | 2025 | 2027 | 2030 | 2035 | 2040 | 2045 | 2050 |
| Proposed Reform: | | | | | | | | | | | |
| Switcher | | | | | | 47.8 | 45.9 | 43.1 | 44.5 | 41.4 | 38.6 |
| Transitional | | | 57.7 | 53.7 | 46.3 | | | | | | |
| Exempt | 53.3 | 58.3 | | | | | | | | | |
| White Paper Reform | | | | | | | | | | | |
| Switcher | | | | | | 42.7 | 37.7 | 32.4 | 28.8 | 26.1 | 24.1 |
| Transitional | | | 54.0 | 48.6 | 42.1 | | | | | | |
| Exempt | 53.3 | 58.4 | | | | | | | | | |
| 'No Reform': | | | | | | | | | | | |
| Switcher | | | | | | 34.9 | 31.0 | 25.5 | 21.2 | 17.4 | 14.1 |
| Transitional | | | 50.6 | 45.0 | 37.7 | | | | | | |
| Exempt | 53.3 | 58.4 | | | | | | | | | |
| Pensions Deficit to GDP in % points | | | | | | | | | | | |
| Proposed Reform | 2.0 | 3.9 | 4.0 | 3.8 | 3.0 | 2.4 | 2.2 | 1.9 | 2.7 | 2.6 | 2.6 |
| White Paper Reform | 2.6 | 4.5 | 4.6 | 4.5 | 3.8 | 3.8 | 3.4 | 2.7 | 2.5 | 2.2 | 2.1 |
| 'No Reform' | 1.8 | 3.4 | 3.7 | 4.4 | 4.7 | 4.6 | 4.3 | 3.9 | 3.7 | 3.5 | 3.3 |

The reforms proposed to the pensions system as presented in this Report strengthen the adequacy component of the Two-Thirds Pension, and in all delivers a reasonable adequate average replacement rate for the period under review. The deficit of the pensions system for the proposed reform model increases by (0.5%) to (2.6%) on the White Paper reform model. This is a direct consequence of the measures introduced to strengthen the average replacement rates. At a (2.6%) deficit to GDP, the reform model is sustainable.

In presenting its final recommendations, the Group is cautiously confident that the reforms it proposes to the pensions system achieve the goals of securing adequacy and sustainability whilst at the same time provide a good basis upon which consensus, if sincerity and goodwill prevails, can be attained.

The Group, within the constraints of reality, strived hard to avoid a big bang approach to reform and maintained, to the best of its ability, its commitment to seek a staggered, phased and incremental process to reform. Within this context, the Group argues strongly that the pensions system in the future must be managed strategically and that it should be subject to structured five year reviews to account for economic shifts, evolving social norms, demographic changes, and other transitions as they occur.

The Pensions Working Group with the presentation of this Report and the accompanying Supplementary Papers considers the terms of reference presented to it by the Prime Minister on 1st June 2004 as met, and, thus, its work as concluded.

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| No 5: | Second Pillar Pension Schemes |
| No 6: | Investment Principles for Occupational Retirement Schemes |
| No 7: | Determining Adequacy |

Glossary

| | |
|-------------------------------|---|
| Average Replacement Rate: | The pensions income in proportion to the average wage earned. |
| Exempted Group: | Persons who will be 55 years of age and over when the reforms are introduced. |
| 'No Reform' Model: | The pensions system as it prevails today. |
| Reform Model: | The proposed reform of the pensions system as presented in this Report. |
| Second Pillar Pension Scheme: | A private pension offered by financial services providers. This can be either voluntary or mandatory. |
| Switchers Group: | Persons who will be 45 years of age and below when the reforms are introduced. |
| The Group: | The Pensions Working Group. |
| Third Pillar Pension Scheme: | Voluntary financial schemes offered by the private sector for pensions purposes. |
| Transitional Group: | Persons who will be between 54 years of age and 46 years of age when the reforms are introduced. |
| Two-Thirds Pension: | The State pension calculated on 2/3 of the basic wage to a Maximum Pension Income ceiling of Lm6,750. |
| White Paper Model: | The recommendations of the Pensions Working Group as presented in the White Paper, November 2004. |

Introduction
Chapter 01

01.1 Background

Following the publication of the Report of the Pensions Working Group on the reform of the pensions system as a White Paper titled 'Pensions Adequate and Sustainable: Reforms Needed Now to Ensure Adequate and Sustainable Pensions for Future Generations', the Group embarked on an embracing consultation process.

In all, the Group delivered 39 presentations to various stakeholders and held 17 sessions with the media. In tandem with the consultation process, the Group commissioned four studies that were subsequently placed in the public domain:

- | | |
|--|-------------------------------|
| - Economic Impact Assessment | Economic Policy Division |
| - Social Impact Assessment | Management Efficiency Unit |
| - Actuarial Study of Key Recommendations | Hewitt, Bacon and Woodrow Ltd |
| - Survey on People's Attitudes to Pensions | National Statistics Office. |

Following the closure of the consultation process, which was extended by one month to 30th April 2005, the Group received 47 formal submissions. **Supplementary Paper Number 01** titled '**Analysis of Formal Feedback Received**' provides a summary of the main issues and recommendations submitted as well as a synthesis of all the submissions received.

01.2 Main Findings of Studies Commissioned by the Group

The Economic Impact Assessment, the Social Impact Assessment and the Actuarial Study all conclude that a scenario of 'no reform' will render the pensions system inadequate and unsustainable. The studies further conclude that the adoption of the reforms proposed in the White Paper will improve adequacy and will render the pensions system sustainable.

The Social Impact Assessment and the Actuarial Study however conclude that whilst the reform would provide for a far higher level of adequacy as compared to a situation of 'no reform', both studies conclude that the average replacement rate – that is, the level of pension income compared to the average basic wage – would still remain low to assure a decent standard of adequacy. Both studies recommend a series of proposals to the White Paper reforms directed to secure an improved level of adequacy.

It is pertinent to underline that the Economic Impact Assessment concluded that the macro-economic assumptions to the pensions reform options simulation tool (PROST) were far too optimistic and recommended that post-consultation studies should be carried out on a more cautious set of macro-economic assumptions. **Appendix I** presents the changes to the macro-economic assumptions upon which the post-consultation reform proposals are modelled.

01.3 Main Issues Raised in Consultation Feedback Received

The consultation feedback received was unanimous in agreeing that the pensions system unless reformed would lead to grave consequences. The message is clear: 'no reform' to the pensions system is not an option. The consultation feedback also agreed that the White Paper provided a good basis for discussion on this national and sensitive matter. Nevertheless, and as expected, some agreed with the proposals in part or in whole, others disagreed in part or in whole on the solutions to be adopted. In general, the following were the major concerns raised:

01. **Maximum Pension Income:** The general position is that the Maximum Pension Income of Lm6,750 introduced in 1981 is no longer adequate and must be changed. Various ways of how this should be achieved are proposed.

02. **Pension Indexation to Wages:** The general position is that a strict indexation with inflation would result in a state of play where the Two-Thirds Pension would become a flat pension as most people will, over the period under review, earn beyond the Maximum Pension Income ceiling. This would result from the fact that wage increases, generally, tend to outstrip inflation.
03. **Increase in Statutory Retirement Age:** Most feedback agrees, with the exception of a number of unions, that the retirement age should increase to 65 years. Nevertheless, concerns were raised on the fact that particular jobs, mainly those related to manual workers, due to their intrinsic nature cannot be carried out by persons who are past a certain age.
04. **Changes to the Accumulation and Calculation Parameters of the Two-Thirds Pension:** These recommendations were received negatively. The main concern is directed to the proposal of departing from final salary calculation to linking the calculation of the pension with the contributions paid over one's accumulation period. The general consensus is that this recommendation will severely impact the adequacy of one's pensions.
05. **Private Pensions:** Whilst there is unanimous agreement to the introduction of Second Pillar Pensions on a voluntary basis the general position is not in favour a mandatory introduction.
06. **Channelling of Pensions Contributions to the Health Fund:** Whilst there is unanimous agreement that health reform is necessary the general position is that pension contributions should be directed for the purpose they are collected: pensions.

01.4 Methodology

The Group applied the following methodology in the preparation of this final Report:

- (a) It assessed the formal feedback received.
- (b) It reviewed the afore mentioned studies it commissioned.
- (c) It assessed and reviewed the recommendations it proposed in the White Paper within the context of (a) and (b) above.
- (d) It calibrated the economic assumptions underpinning the PROST pension reform simulation tool and carried out a wide range of modelling, including where possible of submissions received.
- (e) It drew up Supplementary Papers on the following:
 - No 1: Analysis of Formal Feedback Received.
 - No 2 (a): Defining Manual Workers and Workers in other Demanding Jobs
 - No 2 (b): 65 Years Retirement Age: Impact on Manual Workers and other Demanding Jobs.
 - No 3: Pension Measures to Incentivise Female Participation in the Work Force.
 - No 4: Use of Property for Retirement.
 - No 5: Second Pillar Pension Schemes.
 - No 6: Investment Principles for Occupational Retirement Schemes.
 - No 7: Determining Adequacy.

The Group was admirably supported by a Technical Team consisting of members from the Cabinet Committees' Support Unit, the Malta Financial Services Authority, the Economic Policy Division, the Management Efficiency Unit and the Department of Social Security. The team worked under the direction of the Chairman of the Pensions Working Group. **Appendix II** presents the members of the Technical Team.

01.5 Acknowledgments

The Pensions Working Group thanks all those persons and bodies who met with it and presented submissions and feedback to guide the Group in this important work.

The Group thanks the economists of the World Bank who made themselves available at all times.

The Group thanks the members of the Technical Team without whom the Group would not have been able to complete this work.

Preparing for the Reform of the Pensions System
Chapter 02

02.1 Publication of Final Report of the Pensions Working Group

The Group is of the considered opinion that this Report and the accompanying supplementary papers are placed in the public domain. The Group continues to believe that continuation of the transparent process adopted to date on this sensitive issue will continue to positively contribute to the mature discussion that has taken place so far.

Original Decision of Principle No 01

Government should positively consider issuing the Report of the Pensions Working Group as a White Paper to facilitate the national discussion and consultation process required on this important matter.

Final Recommendation No 01

The Pensions Working Group recommends that the Government should positively consider placing the Final Report and the accompanying supplementary papers in the public domain to further contribute to the mature debate that has taken place to date on this sensitive issue.

02.2 Strategy for Implementation

The consultation process has validated the Group's conclusion that there is no option but to adopt a process of reform to the pensions system. The consensus reached to date must be built upon, so that agreement is also attained on the conceptual design of a reformed pensions system that is underpinned by the principles of adequacy and sustainability.

A process of reform, however, whilst holistic in terms of the goals sought cannot be on the basis of a 'big bang' approach to implementation. As argued in the White Paper, the Group continues to be of the considered opinion that Malta has sufficient flexibility to adopt a balanced and measured approach to reform in so far that the process of reform is initiated in the immediate future. To achieve this scaled implementation of the reform process, the Group recommends three prongs of implementation.

First. The Group is of the considered opinion that it is not morally just to change the pension parameters of pensioners today. Preparing for one's retirement requires lifestyle decisions taken well in advance of one's retirement. Thus, changes to the contract on pension income of current pensioners would surely leave these persons poorer as they would not have the opportunity to make changes of an economic nature to assist them during their retirement.

Final Recommendation No 02

The Pensions Working Group recommends that there should be no changes to the parameters enjoyed by pensioners or persons who would have retired by the time the proposed reform to the pensions system is embarked up on.

Second. The Group is strongly of the view that the process of reform must be a journey. The changes that should take place in the immediate term should be seen as the start of the process of reform.

Thus, measures should be introduced incrementally. The Group reaffirms the approach it adopted in the White Paper to implementation that this must be staggered and incremental – not only in terms of the said measures themselves, but also of how those measures impact different cohorts of people.

In this regard, the Group proposes that the degree of the impact of the measures constituting the reform should differentiate between three age groups. The first, is the age group that will be 55 years of age and over at the time of the reform. This group is titled as the **'Exempted'** group. Here too, as with current pensioners, the Group believes that changes should be kept to the absolute minimum. The Group argues that persons in this age group would already have made their plans and investment decisions for retirement purposes and thus changing the retirement goal-posts on the eve of their retirement is neither morally acceptable nor just.

The second is the age group between 54 years of age and 46 years of age. This group is titled as the **'Transitional'** group. With regards to this group, the Group, believes that the impacts of certain measures of reform, mainly statutory retirement age, the accumulation period of the Two-Thirds Pension, and the calculation period of the Two-Thirds Pension, are introduced by degrees and thereby affecting persons within the said group differently.

The third, is the age group that would be 45 years of age and below at the time of the reform. This group is titled as the **'Switchers'** group. This age group will be affected by the totality of the reform measures proposed. In essence, this age group will constitute of persons who will totally exit the current pensions system and enter the proposed reformed pensions system.

Final Recommendation No 03

The Pensions Working Group recommends that the process of reform must be a journey with measures introduced incrementally and in a phased manner, differentiating in varying degrees, as and where necessary, between three age cohorts: (a) the Exempted group; (b) the Transitional group; and (c) the Switchers group.

Third. The pensions system constitutes part, albeit a critical and large part, of the broader macro-economic environment. Changes to the pensions system, therefore, cannot be taken in isolation of the macro-economic performance and behaviour of the country over time.

The Group, therefore, strongly recommends that the reform process should be on the basis of Five Year Structured Reviews as this will provide the nation with the ability to introduce, adopt, and adapt measures according to economic behaviour and performance of the nation. Thus, a Five Year Structured Review process avoids the need to adopt a 'big bang' approach but rather allows for an incremental approach with measures adopted in doses and degrees in accordance with the opportunities and challenges that arise over time.

Original Decision of Principle No 02

Whilst the process of pensions reform must be holistic in its design and formulation, implementation of measures constituting the new pensions system should, as far as possible, be staggered and phased.

Final Recommendation No 04

The Pensions Working Groups recommends that the reformed pensions system must be calibrated by means of a Five Year Structured Review to reflect arising opportunities and challenges stemming from the macro-economic performance and behaviour of Malta over time.

**Recommendations for the Reform of the Pensions System to
Render Pensions Adequate and Sustainable**

Chapter 03

03.1 Preventing Social Exclusion

03.1.1 Introducing a Minimum Pension Guarantee

The Group reaffirms its recommendation to establish a Minimum Pension Guarantee with a starting threshold of Lm2,421 – which is established at approximately 50% of the average wage.

Original Decision of Principle No 03

There should be a minimum pension guarantee that acts as a safety-net against social exclusion.

Final Recommendation No 05

The Pensions Working Group reaffirms its recommendation to establish a Minimum Pension Guarantee which is established at approximately 50% the average wage – Lm2,421.

03.1.2 Establishing an Indexation Mechanism for the Minimum Pension Guarantee

It is recognised that the introduction of a Minimum Pension Guarantee ceiling with no mechanism for the adjustment of the Guarantee ceiling would soon render itself ineffective due to inflationary pressures. In this regard, the Group recommended in the White Paper that the Minimum Pension Guarantee should be indexed to the Retail Price Index (RPI) to automatically assure the value of the Guarantee ceiling against inflation.

The simulations carried out by the Group on PROST clearly show that the level of adequacy secured by a pension is highly correlated with the indexation mechanism adopted. Simulations of the reforms proposed in the Report with the RPI indexation mechanism proposed in the White Paper show that the impact of the proposals in terms of improving the average replacement rate is rather marginal. Positive impacts on the average replacement rate, however, emerge as the bias towards wages in the indexation mechanism increases. In this regard, the Group, on the basis of the simulations carried out, concludes that an appropriate mechanism is one that combines wage and inflation increases respectively on the basis of a 70% wages : 30% inflation ratio.

In addition to this indexation the Group believes that a complete indexation of the Guarantee Ceiling to wages should also be introduced as a control lever on the condition that such a mechanism is triggered at the end of each of the Five Year Structured Review subject to the performance of the economy and public finances.

Original Decision of Principle No 04

A fair mechanism needs to be put in place to automatically assure the value of the minimum pension guarantee against inflation.

Final Recommendation No 06

The Pensions Working Group recommends that the Minimum Pensions Guarantee should be automatically indexed to a mechanism that is constituted of 70% wages and 30% inflation. Moreover, the ceiling should be subject to a Control Lever that may be applied following the Five Year Structured Review that could result to an increase of the Guarantee Ceiling by the Average % of Wage Increases occurring between one Five Year Structured Review and the other. Application of this increase to the Guarantee Ceiling would be subject to the performance of the economy and public finances.

03.1.3 Curbing Abuse and Misuse

There is no doubt that the credits to pension contributions established under the Social Security Act directed to assist a person through difficult periods in his or her life - such as unemployment – should continue to be maintained.

Final Recommendation No 07

The Pensions Working Group recommends that credits to a person's pension contributions as established in the Social Security Act (Chapter 318) should continue to be maintained.

Nevertheless, the continued provision of such credits must be on the principle that these credits are directed towards persons who truly and legitimately are in need of such support.

Fraud, misuse and abuse of pension benefits and credits, therefore, must be stamped out as aggressively as possible. The Group commends the work being carried out by the Department for Social Security that has recently constituted an Anti-Fraud Unit.

The Group thus believes that the Department for Social Security should seek to strengthen its anti-fraud efforts by seeking synergies and information-sharing with the Tax Compliance Unit within the Ministry of Finance. The Group is confident that a holistic approach against free riders and abusers would render more positive results to Government, and ultimately to all Maltese citizens who legitimately meet their obligations.

Original Decision of Principle No 05

The new pensions system must be supported by a strong compliance regime to safeguard honest and hard working persons as well as to deter abuse, fraud and mis-use.

Final Recommendation No 08

The Pensions Working Group recommends that the Anti-Fraud Unit of the Department for Social Security should seek synergies and information sharing with the Tax Compliance Unit of the Ministry of Finance so that a holistic approach towards clamping down on abuse, misuse and free-riders is adopted.

03.2 Promoting Solidarity Amongst Generations

03.2.1 Retaining the Two-Thirds Pension as the Main Mechanism to Ensure Solidarity

The Group reaffirms its recommendation that the Two-Thirds Pension must remain as the main pension pillar to ensure solidarity and that participation in the Two-Thirds Pension should continue to be mandatory.

Original Decision of Principle No 25

The Two-Thirds Pension must remain as the main mechanism to ensure solidarity. Participation in the Two-Thirds Pension is to continue to be mandatory.

Final Recommendation No 09

The Pensions Working Group reaffirms this recommendation.

03.2.2 Post-Retirement Pensions Income is Annually Built Up for All Pensioners Uniformly

The Group in the White Paper proposed that the indexation of the post-retirement pensions income should have no relationship to wages and should be linked solely with inflation to safeguard the pension income against purchasing value erosion.

As argued in Section 03.1.2 of this Report when the nature of the indexation mechanism to the Minimum Pension Guarantee ceiling is discussed, the Group is strongly of the opinion that deliberations made also hold for indexation to the post-retirement pensions income.

Original Decision of Principle No 26

Solidarity within generations requires that the First Pillar post-retirement pensions income is annually built up for all pensioners on an annual uniform basis. The annual uniform basis to be applied should be the Retail Price Index.

Final Recommendation No 10

The Pensions Working Group recommends that the post-retirement pensions income should be automatically indexed to a mechanism that is constituted of 70% wages and 30% inflation. Moreover the ceiling should also be subject to a Control Lever that may be applied following the Five Year Structured Review that could result to an increase of the post-retirement pensions income by the Average % of Wage Increases occurring between one Five Year Structured Review and the other. Application of this increase to the post-retirement pensions income would be subject to the performance of the economy and public finances.

03.3 Raising Employment Levels

03.3.1 Raising the Statutory Retirement Age to 65 Years

The increase in the life expectancy of people is seen as one of the greatest phenomena of the Twenty and Twenty-First centuries. International studies show that life expectancy has grown dramatically as a result of improved sanitation, vaccines and health care advances as well as general improvements in the quality of life. In North America and Europe, life expectancy in 1900 was 47 years. In 2000, it stood at 77 years. It is still increasing by 2.5 years every decade. By 2050 it is expected to reach 90 years. The trend is similar all over the world: according to the United States Census Bureau, life expectancy at birth in India is now 64 years; in Mexico 75 years; and in China, 72 years. The global average is now 63 years. Life expectancy in Malta has followed the same trends as mainstream Europe.

Yet the population demographics are impacted not only by life expectancy but also by population aging. The 'baby boom' generation is now reaching its later years. The world is about to confront a surge in the number of older people. According to the United Nations, older people made up 8% of the world's population in 1950. This figure is now 10% and it is projected to reach 21% by 2050 – closing in to 30% in some of the fast aging countries of continental Europe. In Malta, the 60 years and over cohort is expected to reach 31.8% by 2050.

Meanwhile fertility rates have declined sharply in many countries after the baby boom – and they have not recovered. This too is the state of play in Malta – with fertility rates standing at 10.3/1,000 in 2003 as against 39.3/1,000 in 1944.

The impact on the Maltese economy as a consequence of the combination of increased life expectancy, decreasing births and an aging population will be staggering. One dramatic impact will be the change in the ratio of persons of working age to those in retirement years – which will directly impact the sustainability and adequacy of the Two-Thirds Pension which, given that is based on the Pay As You Go Principle, is directly linked to the affects of changes in demographics. The models which the Group carried out show that in a status quo environment the reality of the demographic changes phenomena will see the demographic ratio decline from the current 3.9 workers for every pensioner today to a ratio of 1.5 to 1 pensioner by 2050.

The Group states, in the most unequivocal manner, that a pensions reform that fails to consider the impact of demographic changes is at best mere tinkering of the inevitable collapse of the pensions system.

It is pertinent to underline that changes in demographics will also impact in a negative manner economic growth. This is pertinent to note as one of the arguments made to the Group against its recommendation to rise the retirement age was that this decision would have a negative impact on employment. Studies carried out overseas show otherwise. A report titled 'The Economic and Budgetary Implications of Ageing Populations: An EU Perspective' carried out by the Directorate General Economic and Financial Affairs of the European Union, for example, concludes that the European Union will see its present economic rate of growth fall from 2 to 2 1/4% to about 1 1/4% by 2040 compared to the US which is expected to remain robust at about 2 1/2%. This is a direct consequence of the EU's aging population.

Moreover, an aging population and the demands of a growing elderly population is also expected to have a profound impact on output distribution. The EU is expecting to see its share in global output fall from 18% in 2003 to 10% in 2050. In contrast, the US is projected to increase its share in global output to 26% by 2050 – an increase of 3% percentage points.

In short, Malta's economic growth and output distribution will fall in the event that measures are not taken to maximise Malta's human capacity by rearing into the economy two particular cohorts of human capacity that today are not maximised: persons in their 60s years of age and women.

Original Decision of Principle No 27

The recommendation of the NCWR to increase the statutory retirement age to 65 years is a positive measure directed to broaden the contribution base as well as to enlarge the pool of labour supply.

Final Recommendation No 11

The Pensions Working Group states, in the most unequivocal manner, that a pensions reform that fails to consider the impact of demographic changes will:

- (a) result in mere tinkering of the inevitable collapse of the pensions system; and
- (b) negatively impact economic growth and output.

In the consultation and feedback process the Group received mixed feedback with regards to its recommendation that the statutory retirement age is increased to 65 years of age for both men and women. Some argued that participation beyond 61 years of age should be voluntary on the basis of incentives. Others, representing sectoral working groups, argued that it is unreasonable to expect people in certain manual and non-manual employment to work beyond 61 years of age.

In an attempt to find a solution that would seek a consensus basis, the Group in the preparation of this Report simulated models, with different permutations, that could possibly provide an alternative to an increase of the statutory retirement age to 65 years.

One model simulated a retirement age of 61 years. Another model simulated a statutory retirement age of 63 years under various permutations. The results show that under both scenarios the sustainability of the pensions system would be placed under considerable financial strain.

The conclusion is stark: if people expect, as they rightly do, an adequate pension, then there is no alternative but to increase the statutory retirement age.

Original Decision of Principle No 28

The statutory retirement age of 65 years will be for both men and women.

Final Recommendation No 12

The Pensions Working Group reaffirms this recommendation.

03.3.2 Differentiating Between Manual and Non-Manual Workers for Statutory Retirement Age Purposes

Studies carried out in the United Kingdom by the Pensions Policy Institute show that there is a difference in the life expectancy between non-manual workers and manual workers. The gap in average life expectancy between manual men and non-manual men is 3.5 years; for women it is 2.8 years. In the United Kingdom environment this represents just under 5% and 4% respectively of the life expectancy of an average man or woman. **Supplementary Paper Number 2** titled '**65 Years Retirement Age: Impact on Manual Workers and other Demanding Jobs**' looks at this matter in further depth.

On the basis of the differences in life expectancy between manual and non-manual workers there is merit in considering a different pension retirement age for manual workers. In this regard, the Group proposes that with regards to the Transitional and Switchers groups respectively the retirement age for manual workers is retained at 61 years of age subject to a number of disincentives:

- (a) The person will receive no indexation to the post-retirement pensions income for the period between 62 years and the statutory retirement age of 65 years.
- (b) The person will be eligible for the Second Pillar Pension Scheme at 65 years of age.
- (c) The person will have the Two-Thirds Pension suspended in the event that employment is entered to after the 61 years of age.

The recommended disincentives are not directed to be crippling. The *raison d'être* behind these disincentives is to nudge a person to continue in employment. The Group believes that with strong re-skilling and re-training programmes manual workers can be re-assigned or re-employed in non-manual related activity.

Final Recommendation No 13

The Pensions Working Group believes that given the differences in average life expectancies between manual and non-manual workers there is merit in retaining the 61 years retirement age for manual workers within the Transitional and Switchers groups respectively on the basis of a light disincentive regime.

The Group is aware that the adoption of the above recommendation may result in various sectoral non-manual workers submitting their demands to be excluded from the proposed statutory retirement age. The Group believes that there is no legitimate reason for non-manual workers to be excluded from the proposed statutory retirement age.

Increasing the statutory retirement age for non-manual workers will, of course, demand supporting policies by employers to render later working life more attractive for them. Redeployment, re-assignment, re-skilling, re-training are all tools that can be applied to achieve this.

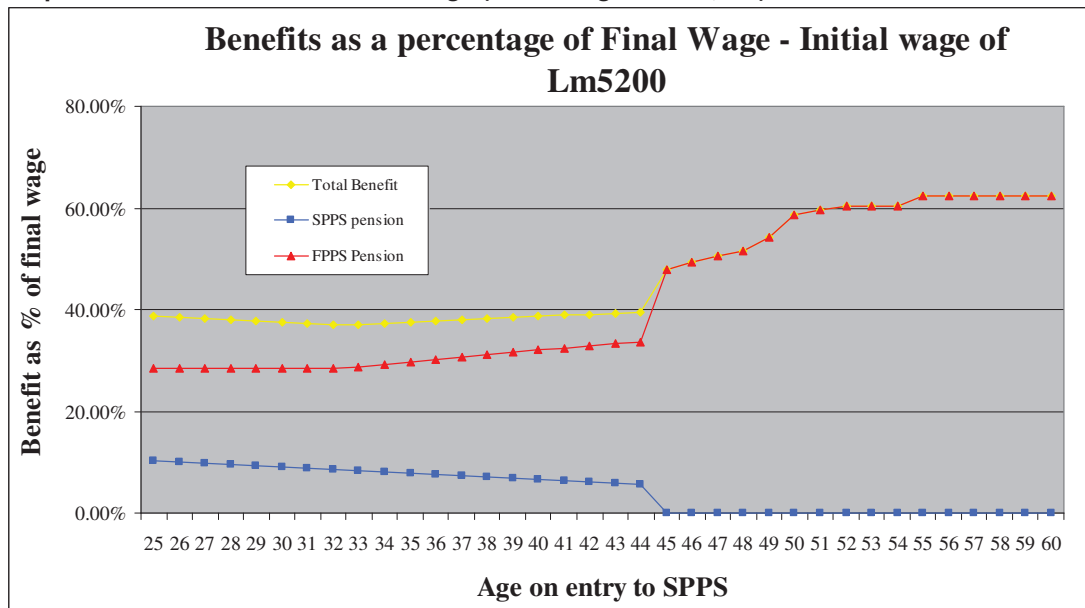
Final Recommendation No 14

The Pensions Working Group believes that there is no legitimate reason for non-manual workers to be excluded from the proposed statutory retirement age, and supporting policies by employers such as redeployment, re-skilling, re-assignment et al, should be introduced to render later working life more attractive.

03.3.3 Phased Introduction of the 65 Years Statutory Retirement Age

The Group reaffirms its position that the increase in the mandatory statutory age from 61 years of age to 65 years of age for non-manual workers should be carried out in an incremental manner. Nevertheless, the actuarial analysis carried by Hewitt, Bacon and Woodrow Ltd show that the White Paper recommendations in this regard create considerable 'cliffs' where the person's pension would be significantly impacted as a direct result of being a day younger or a day older. This is demonstrated in Graph 01 below.

Graph 01: Benefits as a % of Final Wage (Initial Wage of Lm5,200)



In this regard, the Group proposes that the phased increase of the statutory retirement age for non-manual workers is redesigned to minimise such negative affects. Table 01 below presents the recommendations in this regard:

Table 01: Proposed Phasing of the Structural Retirement Age for Non-Manual Workers

| Years of Age as at 1 st January 2007 Age | Retirement |
|---|------------|
| 55 years of age and over | No Change |
| 51 years of age to 54 years of age | 62 years |
| 48 years of age to 50 years of age | 63 years |
| 46 years of age and to 47 years of age | 64 years |
| 45 years of age and below | 65 years. |

Original Decision of Principle No 29

The rising of the statutory retirement age to the proposed 65 years should be gradual with women reaching the 61 year threshold in 1st January 2007. Subsequent to which the statutory retirement age is to increase as shown in below:

| Years of Age as at 1st January 2007 | Retirement Age |
|---|-----------------------|
| 55 years of age and over | No Change |
| 52 years of age to 54 years of age | 62 years |
| 49 years of age to 51 years of age | 63 years |
| 48 years of age and below | 65 years. |

Final Recommendation No 15

The Pensions Working Group recommends that the statutory retirement age for non-manual workers to the proposed 65 years should be gradual with women reaching the 61 year threshold in 1st January 2007. Subsequent to which, the statutory retirement age is to increase as shown below:

| Years of Age as at 1st January 2007 | Retirement Age |
|---|-----------------------|
| 55 years of age and over | No Change |
| 51 years of age to 54 years of age | 62 years |
| 48 years of age to 50 years of age | 63 years |
| 46 years of age and to 47 years of age | 64 years |
| 45 years of age and below | 65 years. |

03.3.4 Enabling Gradual Opt-Out between 61 Years and 65 Years of Age

The Group reaffirms its recommendation that a non-manual worker should be provided with the opportunity to opt out of employment once the 61 years retirement age is reached. Nevertheless, the Group is strongly of the opinion that a decision to opt out of employment to attain a higher quality of life should be at cost. In essence, therefore, opting out of the labour market should be subject to a heavy disincentive regime.

In this regard the Group proposes that:

- (a) a non-manual worker who decides to opt out of the labour market between 62 years of age and 65 years of age should be penalised by 6% of the pension's value for every year opted out. This would mean that:
 - a non-manual worker who opts out at 64 years will receive a pension at 94% of the pension entitled to if the person worked up to 65 years of age.
 - a non-manual worker who opts out at 63 years will receive a pension at 88% of the pension entitled to if the person worked up to 65 years of age.
 - a non-manual worker who opts out at 62 years will receive a pension at 82% of the pension entitled to if the person worked up to 65 years of age.
 - a non-manual worker who opts out at 61 years will receive a pension at 76% of the pension entitled to if the person worked up to 65 years of age.
- (b) the pension value will be frozen for the duration of its entitlement at the value awarded according to age at the time of the opt-out.

- (c) the post-retirement pension indexation is frozen until the person reaches the statutory retirement age.
- (d) the person will be entitled to the Second Pillar Pension once the statutory retirement age is reached.

Original Decision of Principle No 29

Individuals should be able to opt for a shorter career between the age of 61 to 65 years on the basis of proportionate benefits.

Final Recommendation No 16

The Pensions Working Group recommends that a non-manual worker will have the option to opt out of the labour market between 61 years of age and 65 years of age subject to a heavy disincentive regime that would include a loss of 6% of the full pension entitlement for each year opted out; a freeze on the value of the pension; and a freeze on the post-retirement pension indexation until the statutory retirement age is reached.

03.3.5 Establishing an Immigration Policy

The demographics for Malta issued by the National Statistics Office show that the population will fall to 333,800 by 2050. The models simulated for in the design of the reformed pensions system assume a net immigration (500 persons) and returned migrants (150 persons) influx of 650 persons annually. This is estimated to increase the Maltese population to approximately 360,000 by 2050. It is pertinent to note that Euro Stat earlier this year projected a Maltese population of over 500,000 by 2050. The fundamental assumption behind this projection was a net immigration influx of 2,500 persons annually.

Whilst the Group is of the considered opinion that the Euro Stat assumption for immigration is unrealistic, the reality, as demonstrated by the projections of Malta's demographics for 2050, is that an immigration policy to mitigate against the anticipated fall in the Maltese population is a necessity.

The Group proposes that the Government should introduce an immigration policy that seeks to attract immigrant labour equipped with the skills required to meet gaps in the human stock necessary for Malta's economic growth.

Final Recommendation No 17

The Pensions Working Group proposes that the Government considers introducing an immigration policy that seeks to attract immigrant labour with the skills required to meet gaps in the human stock necessary for Malta's economic growth.

03.3.6 Incentivising Continued Participation in the Labour Market beyond the Statutory Retirement Age

The Group reaffirms the recommendation in the White Paper that persons should be encouraged and incentivised to work beyond the 65 years of age subject to the payment of the Two-Thirds Pension Contribution. The Group continues to be of the considered opinion that the contribution paid will not accrue to the person but will, rather, be placed in the Pensions Account. This would constitute a measure for inter-generational solidarity. It is pertinent to underline that such continued employment will not be automatic but subject to the employer's consent.

Original Decision of Principle No 30

A person may opt to continue to work beyond the new statutory retirement age, whilst enjoying the Two-Thirds Pension and Second Pillar Pension, with no capping on the income earned, subject to the payment of the Two-Thirds Pension contribution.

Final Recommendation No 18

The Pensions Working Group reaffirms this recommendation.

The Group, however, is of the considered opinion that the possibility to incentivise continued participation in the labour market should not be provided to the Switchers group only.

It is proposed that the incentivisation for continued participation in the labour market should also be made available to Exempted and the Transitional groups respectively. In designing an incentivisation system for non-manual workers within these two groups note should be taken of the possibility that immediate extension for continued employment to these groups together with the increase of the statutory retirement age could block openings for younger persons.

International studies show that persons who retire seek a form of employment – not necessarily full time – but on a flexible basis which allows them to enjoy both retirement whilst at the same securing income as well as the positive aspects related to work: the knowledge of contributing; the social aspects of work; better health; et al.

Thus, the Group proposes that non-manual persons in the Exempted and Transitional groups respectively should be allowed to continue to work and earn a combined maximum of Lm10,000 between the pension and the income earned subject to:

- (a) the person will continue to pay his or her contribution which will, however, be paid to the Pensions Account thereby constituting a measure for inter-generational solidarity.
- (b) employment will be on a part-time basis.
- (c) continued employment will not be automatic but subject to the employer's consent.

The conditions referred to above will apply until the non-manual worker reaches the age of 65 years. Subsequent to that the proposal in Recommendation 18 will apply.

Final Recommendation No 19

The Pensions Working Group recommends that non-manual workers in the Exempt and Transitional groups respectively should be incentivised to work beyond their retirement and earn a combined pensions and earnings income of Lm10,000 subject that the contribution will be paid as an inter-generational solidarity contribution; employment is of a part-time nature; and continued employment in one's job is dependent on the employer's consent. This condition will apply until the person reaches 65 years of age, subsequent to which the proposal in Recommendation 18 will apply.

03.3.7 Reviewing the Current Invalidation Pensions Scheme

The Group reaffirms the recommendation that the current invalidity pensions scheme should be reviewed with a view to tighten the eligibility criteria as well as to adopt the principle of 'rehabilitation or alternative work before pension'.

Original Decision of Principle No 31

The current invalidity pensions scheme should be reviewed with a view to tighten the eligibility criteria as well as to adopt the principle of 'rehabilitation or alternative work before pension'.

Final Recommendation No 20

The Pensions Working Group reaffirms this recommendation.

03.3.8 Atypical Employment Nature of Women

Supplementary Paper Number 3 titled '**Pension Measures to Incentivise Female Participation in the Work Force**' reviews in detail the matter of women in employment. Following this detailed analysis, the Group reaffirms its recommendation that the reality of woman's atypical employment and the resultant entitlement should be recognised and pension policy instruments that reflect this reality should be introduced.

Original Decision of Principle No 40

The reality of woman's atypical employment and the resultant entitlement handicaps should be recognised and pension policy instruments that reflect this reality are to be introduced.

Final Recommendation No 21

The Pensions Working Group reaffirms this recommendation.

03.3.9 Parental Responsibilities in Relation to Child Bearing and Raising

The Group reaffirms its recommendation that the pensions system should be leveraged in a positive manner to enable parents to balance parental responsibilities in relation to child bearing and raising with career responsibilities and, with particular regard to women, to remain in the labour force.

The afore mentioned Supplementary Paper reviews the options available in this regard. The Group recommends that a system of credits to the pensions system for parents who take time off for child bearing and raising should be positively considered. It is pertinent to underline, that the introduction of such a system should also act as a positive family growth measure as it will assist parents to balance financial needs with family planning.

Thus, the Group recommends that parents should be provided with a two year pension credit for each child born following the introduction of the pensions reform subject to the condition that the parent will return to work for an equivalent time period.

Unfortunately, the PROST pensions simulation tool does not allow the Group to cost the impact of this recommendation – with positive financing stemming from the fact that more women will remain in the work force thereby increasing the labour stock and contributions earned; with negative financing stemming from the cost to the Pensions Account for the payment of the said credits. Thus, whilst the Group supports, in principle, this way forward, it proposes that a final determination should take place only following a cost-benefit assessment of this recommendation.

Original Decision of Principle No 41

A policy instrument that takes into account parental responsibilities in relation to child bearing and child raising periods by providing for the phased crediting of the individual's contributions as well as the payment of voluntary contributions under established conditions should be positively considered.

Final Recommendation No 22

The Pensions Working Group recommends that parents should be provided with a two year pension credit for each child born following the introduction of the pensions reform subject to the condition that the parent will return to work for an equivalent time period. Given that costing of this recommendation is not possible through the PROST pensions simulation tool, the Group proposes that a final determination by Government should only take place following a cost-benefit assessment of this recommendation.

The Group reaffirms its recommendation that the reform of pensions in this regard should be supported by the reinforcement of current as well as the introduction of new family friendly measures to enable the balance of work and family and thus ensure not only increased participation but also the retention of the women in the labour force.

The Group in the afore mentioned supplementary paper proposes a series of measures in this regard which it believes that the Government should seriously consider for introduction.

Original Decision of Principle No 42

The introduction of family friendly measures to enable the balance of work and family life and thus ensure not only increased participation but also the retention of women in the labour force should continue to be re-inforced.

Final Recommendation No 23

The Pensions Working Group reaffirms this recommendation. A number of recommendations in this regard are presented in the Supplementary Paper titled: **Pensions Measures to Incentivise Female Participation in the Work Force.**

03.3.10 Rapidly Changing Employment and Career Patterns

There is no doubt that employment and career patterns are changing rapidly. There is a shift towards employment in definite contracts; changing employment during one's career; temporary employment; tele-working employment; reduced hours employment; short term contract employment, et al.

In the face of changing patterns, stemming from resultant life styles changes, it is important to ensure that barriers to new forms of flexible employment are removed in order to, on the one hand, ensure that regulation reflects emerging new norms in society, and on the other hand, render such form of employment attractive without the potential consequence of driving such employment into the shadow economy.

One of the measures that is seen as a barrier to this form of employment is the Minimum National Insurance Contribution paid on part-time work. The Minimum National Insurance Contribution stands at Lm5.14 per week for both the employee and the employer irrespective of the income earned in so far that the said income is equal to or below Lm51.38 per week.

Data obtained from the Department for Social Security shows the following basic wage categories of part time-workers as at 31st December 2002:

Table 02: Part Time Workers and contributions earned

| Weekly Wage | Workers | % | Contributions Lm |
|---------------|---------|-------|---------------------|
| 0.00 – 10.00 | 3,415 | 21.06 | 1,825,552 |
| 10.01 – 20.00 | 1,807 | 11.15 | 965,950 |
| 20.01 – 30.00 | 2,588 | 15.97 | 1,383,441 |
| 30.01 – 40.00 | 3,097 | 19.11 | 1,655,532 |
| 40.01 – 50.00 | 5,301 | 32.71 | 2,833,703 |
| | 16,208 | | 8,664,148 |

The above shows that 21.06% of part-timers earn Lm10 per week or less – which means that 51.4%, more than half of the income earned is paid as a contribution. In terms of people earning Lm30 per week this stands at 17.13%, and 10.28% for persons earning Lm50 per week.

From the above, it can be construed that the Minimum National Insurance Contribution can act as an inhibitor to flexi-related employment. The case for the Minimum National Insurance Contribution, however, argues that such a minimum threshold assures the worker with a minimum pension income – which would not be possible in the event that the pension is calculated in proportion to the benefits paid.

The Group believes that the net-effect to the local economy will be a positive one in a scenario where the Minimum National Insurance Contribution is removed. Nevertheless, it has no hard data to support this supposition.

Thus, it proposes that Government undertakes a cost-benefit assessment to evaluate whether the removal of the Minimum National Insurance Contribution would have a positive impact to the economy and if so, then it should take steps to have it removed.

Original Decision of Principle No 43

Measures need to be taken to remove those elements in the system that encourage periods of inactivity or activity within the informal economy when people need to be attracted to participate in the labour market even on a part-time basis.

Final Recommendation No 24

Whilst the Pensions Working Group believes that should the Minimum National Insurance Contribution be removed the net-effect to the local economy will be a positive one, it recommends that the Government should undertake a cost-benefit assessment prior to a final decision in this regard.

03.3.11 Life Long Learning

The Group reaffirms its recommendation that a reformed pensions system should be used as a positive instrument to leverage life long learning.

In this regard, the Group recommends that a person of 30 years of age and above who takes a period between 6 months and 12 months for academic or vocational higher education with institutions accredited with the Ministry for Education, Youth and Employment should have their pension credited.

The Group further recommends that a person who decides to follow a Doctorate Degree (PhD) with an institution accredited with the Ministry for Education, Youth and Employment should have their pension credited for their first year of study as well as the ability to back-fill the unpaid contributions of the remaining years of study at any point in time prior to the person's retirement; subject to the condition that the contribution paid will equate to the amount due at the time the payment is made.

Original Decision of Principle No 44

The design of policy instruments that account for 'credits' for the undertaking of unpaid periods for training, reskilling and continuous development should be positively considered.

Final Recommendation No 25

The Pensions Working Group recommends that a person:

- (a) of 30 years of age and above who takes a period between 6 months and 12 months for academic or vocational higher education should have his or her pension credited; and.
- (b) who follows a Doctorate Degree (PhD) should have his or her pension credited for the first year of study as well as the ability to back-fill the unpaid contributions of the remaining years of study at any point in time prior to his or her retirement, subject to the condition that the contribution paid will equate to the amount due at the time the payment is made.

03.4 Adjusting the Existing Pensions System in a Balanced Way

03.4.1 The Contributions Calculation Base-line of the Two-Thirds Pension

The Group reaffirms the recommendation that the contributions calculation base-line for the Two-Thirds Pension should be retained on the basic salary.

Original Decision of Principle No 32

The contributions calculation base-line for the Two-Thirds Pension should be retained on the basic salary.

Final Recommendation No 26

The Pensions Working Group reaffirms this recommendation.

03.4.2 The Contributions Period for the Accumulation of the Two-Thirds Pension

The Group in the White Paper proposed that the contributions period for the accumulation of the Two-Thirds Pension should be incrementally increased from 30 to 40 years.

During the consultation process issues were raised on the lengthening of the accumulation period. Nevertheless, the Group continues to up-hold the rationale it placed in the White Paper that the contribution period should be equated to a person's working life rather than to a part of it.

In upholding this rationale the Group is recognisant of the fact that a 40 year contribution period may affect people that proceed to tertiary and post-tertiary education – in that studies completed at years 26 or 27 or 28 would allow them to accumulate contributions over a 39, 38 or 37 year period.

The Group argues that such a state of play is socially justifiable for two reasons. First, students are financially assisted to carry out their tertiary education. Hence, in the event that they need to back-fill in terms of contributions paid to reach the 40 year contribution period they would be contributing back in part the assistance provided to them by society in general to extend their education in the first place. Second, statistical data shows that people with tertiary education are amongst the higher income earners. Thus, there are no social justifiable concerns that would impede such persons to balance their contribution periods in the event that they accumulate below the proposed contributions period.

Final Recommendation No 27

The Pensions Working Group reaffirms the recommendation that the contribution period for the accumulation of the Two-Thirds Pension is increased from 30 years to 40 years.

The actuarial studies show that the phasing proposed in the White Paper for increasing the contributory years from 30 to 40 years would result in 'cliffs' similar to that experienced under the original phased increase to the new statutory retirement age discussed earlier.

In this regard, the Group proposes that the phasing of the increase in the accumulation of the contributory period is smoothed to minimise to the extent possible the occurrence of such carves. Table 03 below presents the recommendations in this regard.

Table 03: Proposed Phasing of New Accumulation Period

| Years of Age as at 1st January 2007 | Accumulation Period |
|---|----------------------------|
| 55 years of age and over | No Change |
| 54 years of age | 31 years |
| 53 years of age | 32 years |
| 52 years of age | 33 years |
| 51 years of age | 34 years |
| 50 years of age | 35 years |
| 49 years of age | 36 years |
| 48 years of age | 37 years |
| 47 years of age | 38 years |
| 46 years of age | 39 years |
| 45 years of age | 40 years. |

Original Decision of Principle No 33

The contribution period for the accumulation of the Two-Thirds Pension should be as shown below:

| Years of Age as at 1st January 2007 | Accumulation Period |
|---|----------------------------|
| 46 years of age and over | No Change |
| 40 years of age to 45 years of age | 35 years |
| 39 years of age and below | 40 years. |

Final Recommendation No 28

The Pensions Working Group recommends that the contribution period for the accumulation of the Two-Thirds Pension should be as shown below:

| Years of Age as at 1st January 2007 | Accumulation Period |
|---|----------------------------|
| 55 years of age and over | No Change |
| 54 years of age | 31 years |
| 53 years of age | 32 years |
| 52 years of age | 33 years |
| 51 years of age | 34 years |
| 50 years of age | 35 years |
| 49 years of age | 36 years |
| 48 years of age | 37 years |
| 47 years of age | 38 years |
| 46 years of age | 39 years |
| 45 years of age | 40 years. |

The situation may arise that persons falling within the proposed age cohorts may need to make voluntary payments to bridge any gaps in the contribution record necessary to accumulate the periods proposed above. The Group is, therefore, of the considered opinion that persons should be allowed to do so on the condition that payment to reach the accumulation period would be at the contributory rates at the time payment is made.

Final Recommendation No 29

The Pensions Working Group recommends that persons should be allowed to bridge any gaps to meet their respective accumulation periods; subject that payment to reach the accumulation period would be at the contributory rates at the time payment is made.

03.4.3 The Time Based Period for the Calculation of the Two-Thirds Pension

The White Paper proposed that the calculation of the Two-Thirds Pension for Class I contributors should no longer be pegged to a final years' salaries mechanism but rather should reflect a truer and fairer picture of a person's working life. It thus proposed that there should no longer be a distinction between the calculation period of Class I (employees) and Class II (self employed persons) contributors. The White Paper proposed a 40 year calculation period.

As stated in the introductory part of this Report, this recommendation was, perhaps, the one amongst the 44 recommendations presented in the White Paper that generated the most emotive response. The argument put forward is that this recommendation will devalue the Two-Thirds Pension considerably; and in doing so, the *raison d'être* of the Two-Thirds Pension as the cornerstone for adequacy would be seriously undermined.

Having assessed the feedback received the Group concludes as follows. First, it continues to believe that the current calculation period which is biased towards the final years' salaries is not just: it provides room for abuse and does not attain equity between the contributions made by a person during his or her lifetime and the benefits that he or she will accrue on retirement age. Thus, as a matter of principle, the Group continues to be of the considered opinion that the new pensions system must depart from the existing mechanism.

Second, the Group recognises that in a state of play where the Maximum Pensions Income ceiling has remained static since 1981, the Two-Thirds Pension is slowly but increasingly being rendered into a flat pension. Thus, within this reality, the Group acknowledges that a shift to a 40 year contributory period will impact adequacy negatively.

As a consequence of the above, the Group explored a variant of options based on the feedback received. Options considered ranged from an incremental phasing of the calculation period amongst current workers with the full 40 year calculation period to be introduced for persons newly joining the labour force to an averaging period that covers a period longer than the current final years' salaries mechanism.

The Group concludes that the fairest option that balances its philosophical approach to this issue with the concerns of adequacy is to adopt a calculation period that is based on the average of the best 10 years from the last 20 years of a person's employment. Table 04 presents the recommendations in this regard.

Table 04: Proposed Phasing of New Calculation Period

| Years of Age as at 1 st January 2007 Period | Calculation |
|---|---|
| 55 years of age and over | No Change |
| 50 years of age to 54 years of age | Average of best 5 years |
| 46 years of age to 49 years of age | Average of best 8 years |
| 45 years of age and below | Average of the best 10 years from the last 20 years. |

Original Decision of Principle No 34

The calculation period of the Two-Thirds Pension should be based on an average of the 40 year contributions accumulation period and introduced as shown below:

| Years of Age as at 1st January 2007 | Calculation Period |
|---|---------------------------|
| 50 years of age and over | No Change |
| 50 years of age to 54 years of age | Average of best 5 years |
| 45 years of age to 49 years of age | Average of best 10 years |
| 44 years of age and below | 40 years. |

Final Recommendation No 30

The Pensions Working Group recommends that the calculation period of the Two-Thirds Pension should be on the basis of the average of the best 10 years from the last 20 years. The calculation period should be introduced as shown below:

| Years of Age as at 1st January 2007 | Calculation Period |
|---|--|
| 55 years of age and over | No Change |
| 50 years of age to 54 years of age | Average of best 5 years |
| 46 years of age to 49 years of age | Average of best 8 years |
| 45 years of age and below | Average of the best 10 years from the last 20 years. |

The Group reaffirms its recommendation that there should be no discrimination between self-employed and employed persons on the time base period upon which the Two-Thirds Pension is calculated.

Original Decision of Principle No 34

There should be no discrimination between self-employed and employed persons on the time base period upon which a Two-Thirds Pension is calculated.

Final Recommendation No 31

The Pensions Working Group reaffirms this recommendation.

03.4.4 The Maximum Two-Thirds Pension Ceiling

The Group in the White Paper proposed that the Maximum Pension Income ceiling should, for the time being, be retained at its current level and increased annually to reflect inflation. It is pertinent to clarify that the Group was not against the raising of the Maximum Pensions Income ceiling. Its concern rested with the timing of the increase of the ceiling – in that whether given the current economic conditions an increase in the ceiling today would be appropriate.

The feedback arising from the consultation is that given the fact that the Maximum Pension Income ceiling of Lm6,750 has remained static since 1981 and that wages throughout this period have increased considerably the retention of the Maximum Pension Income ceiling does not constitute a tenable recommendation.

The Group has reviewed the relationship between its recommendation of retaining the Maximum Pension Income ceiling to its current level with an annual RPI adjustment. The post-consultation findings show that the retention of the current Maximum Pension Income ceiling is one of the key reasons of why the average replacement rate, that is the relationship between wages and the Two-Thirds Pension, whilst improving over a 'no reform' scenario, remains relatively low. In essence, the financial impact of retaining the Maximum Pension Income ceiling at its current level together with an indexation mechanism linked solely to inflation would lead to a state of play where the Two-Thirds Pension will sooner rather than later become a flat rate pension as the basic wage of people will over the period under review exceed this ceiling. A direct consequence of this is that the average replacement rate will decrease at a rapid rate thereby securing a lower level of adequacy.

The Group concludes that its original recommendation is reviewed and that a decision to increase the Maximum Pension Income ceiling is positively considered. A determination in this regard requires three fundamental decisions.

First, the determination of the new Maximum Pension Income ceiling. The feedback on this matter varied. Some requested that the Maximum Pension Income ceiling is adjusted by inflation ex-post to 1981 – which would set the ceiling at, approximately, slightly over Lm10,000 – which would render the maximum pension at Lm6,667. Others recommended that it should be increased to this level in a number of stages. Others recommended that such an ex-post adjustment should be backdated to the mid 1990s which would set the ceiling at, approximately, slightly over Lm9,000 – which would render the maximum pension at Lm6,000.

The Group understands that a determination of a new ceiling must balance, on the one hand adequacy, and on the other, the impact that such an increase will have on disposable income and employers' competitiveness as a result of the corresponding increase in the contribution paid. In order to reach such a determination it is pertinent to look at how pension income levels will increase over a ten year period.

PROST shows that the persons earning income over the current Maximum Pension Income ceiling stands at 45% in 2003. This is expected to increase by 17% to 62% by 2010; and by a further 5% to 67% by 2014. In essence, therefore, this shows that the % of persons who will pay an increased contribution as a direct result of the proposed increase in the Maximum Pension Income ceiling, would increase by 22% – thereby leading one to conclude that such an increase is manageable. It is also pertinent to underline that not all such increases would necessarily fall between the current and a new Maximum Pension Income ceiling: persons who earn beyond a newly proposed Maximum Pension Income ceiling would still have their contributions capped – albeit to the new ceiling. Nor would persons whose earnings fall within the basic average wage will be affected.

The Group has simulated various ceiling permutations on a number of reform models. Within the context of the overall recommendations being presented in this Report, the Group proposes that the Maximum Pension Income ceiling is set at Lm9,000 as from 1st January 2007.

Original Decision of Principle No 36

The ceiling of the First Pillar's MPI should be the current MPI *adjusted yearly to reflect inflation.*

Final Recommendation No 32

The Pensions Working Group recommends that the Maximum Pension Income ceiling should be set at Lm9,000 as from 1st January 2007.

Second, the determination of age cohorts that will be impacted by this recommendation. The Group proposes that this recommendation is directed towards the Switchers Group. The adoption of this recommendation is seen as essential in order to maintain the sustainability of the pensions system. The receipt of a higher pension as the result of an increased Maximum Pension Income ceiling demands that a person would have fully contributed on the basis of the new ceiling.

In the absence of this, persons would be provided with a higher pension income when they would not have contributed to such an increase – and thus placing the sustainability of the reformed pensions system under pressure.

Final Recommendation No 33

The Pensions Working Group recommends that the proposed increase in the Maximum Pension Income ceiling will be directed to the Switchers Group.

Persons who are in the Exempted and Transitional groups respectively will not be impacted by this measure on the basis that the former are exempted from and the latter incrementally impacted by the proposed changes relating to the increase in the statutory retirement age, accumulation of the contributions period, and the accumulation of the calculation period.

Final Recommendation No 34

The Pensions Working Group recommends that persons who are in the Exempted and Transitional groups respectively will not be impacted by the proposed increase in the Maximum Pension Income ceiling.

Third, the determination of the mechanism to be applied to the Maximum Pension Income ceiling to ensure that this increases over time and thus safeguarding it against inflation erosion as well as to secure an adequate replacement. The Group in the White Paper had proposed that the indexation of the Maximum Pensions Income ceiling should have no relationship to wages and should be linked solely with inflation to safeguard the pension income against purchasing value erosion.

The Group recommends that the recommendation presented in Section 03.1.2 should also apply for the indexation to the Maximum Pension Income ceiling.

Original Decision of Principle No 36

The ceiling of the First Pillar's MPI should be the current MPI adjusted yearly to reflect inflation.

Final Recommendation No 35

The Pensions Working Group recommends that the Maximum Pension Income ceiling should be automatically indexed to a mechanism that is constituted of 70% wages and 30% inflation. It will also be subject to a Control Lever that may be applied following a Five Year Structured Review that could result to an increase of the Maximum Pension Income ceiling by the Average % of Wage Increases occurring between one Five Year Structured Review and the other. Application of such an increase to the Maximum Pension Income ceiling would be subject to the performance of the economy and public finances.

03.4.5 The Revenue Base-line for the Determination of the Two-Thirds Pension

The Group reaffirms its recommendation that the revenue base-line for the determination of the Two-Thirds Pension should remain two-thirds of the basic wage.

Original Decision of Principle No 36

The revenue base line for the determination of the Two-Thirds Pension should remain two-thirds of the basic wage.

Final Recommendation No 36

The Pensions Working Group reaffirms this recommendation.

03.4.6 Contributions to be Paid on the Two-Thirds Pension

During both the consultation and discussion process the argument was made that the Government's direction for pension reform to attain adequacy and sustainability would be to increase the Class I and Class II contributions on the Two-Thirds Pension as against the introduction of a mandatory Second Pillar Pension Scheme.

Whilst the net effect on both disposable income and competitiveness by an increase of the Class I and Class II contributions would be similar to the introduction of a mandatory Second Pillar Pension Scheme, the Group, as a matter of principle, disagrees with this approach for two fundamental reasons.

First. It is strongly underlined that a policy to maintain the Two-Third Pension as the sole basis of one's pension income will increase the risk of the ability to provide a sustainable and adequate pension. This conclusion stems from the fact that the Two-Thirds Pension, due to its Pay As You Go underpinnings, is susceptible to demographic risks. Thus, in a social environment of a rapidly aging and decreasing population maintaining a pensions system that is entirely dependent on demographics will create further problems in the foreseeable future.

The Second Pillar Pension Scheme, on the other hand, is dependent on market returns. Thus the introduction of a pensions system that establishes two prongs – one dependent on demographic risk and the other on market risk – will provide for a far more secure pensions environment. The argument is made that market risks will intrinsically jeopardise the potential returns of a pension income stemming from the Second Pillar Pension Scheme as against the perceived guarantee that the State will meet its dues.

The Group refutes this argument. Perceived must be underlined. Ultimately Government can only meet its guarantees either through the increase in taxation or the channelling of revenue from other key policy areas to make good for arising shortfalls. In essence, there is no such thing as an 'iron-clad' government guarantee.

On the matter of returns, it should be noted that long term Government of Malta Treasury bonds, which are acknowledged by all to be secure financial market investments, provide a real rate of return of, at least, 5% - which is far higher than the average savings accounts interests return on investment in Banks. Moreover, the investment parameters introduced, which are discussed further on in this Report, will be designed to ensure that the impact of financial and equity market failures is minimised. Thus, the Group continues to be strongly of the opinion that a multi-pillared approach to a reformed pensions system is a more appropriate and secure approach that safeguards a person's income, given that such an approach diversifies risks.

Second. The Group subscribes to the principle that if a person is to be mandated to invest more to have a pension income that brings one closer to one's standard of living as enjoyed during employment than that person should have the right to invest the additional investment or contribution to secure the optimum return possible. This principle intrinsically demands that such an investment is made in a private pension as against channelling the additional contribution paid into the State pension fund.

It is pertinent to underline that to date successive administrations have failed to establish a pension fund. Rather, revenue generated from contributions, which are specifically meant to contribute to one's pension income, are directed into the Consolidated Fund to finance general government activity. In truth, successive administrations have failed to manage contributions related to pensions as an investment directed to secure the maximum return to a person.

| Original Decision of Principle No 36 | |
|---|---|
| | The Class I and the Class II contributions should remain unchanged. |

In conclusion on this matter the Group proposes that the contributions will be paid as follows:

- | | | |
|-----|---------------------|---|
| (a) | Switchers Group: | New Maximum Pension Income ceiling + Annual Adjustments to ceiling. |
| (b) | Transitional Group: | Annual Adjustments to ceiling. |
| (c) | Exempt Group: | Annual Adjustments to ceiling. |

| Final Recommendation No 37 | | |
|-----------------------------------|---|--|
| | The Pensions Working Group recommends that whilst the Class I and Class II should remain unchanged, contributions should be paid on the basis of the recommendations on the Maximum Pension Income ceiling and its indexation and will be applied as follows: | |
| (a) | Switchers Group: | New Maximum Pension Income ceiling + Annual Indexation Adjustments to ceiling. |
| (b) | Transitional Group: | Annual Indexation Adjustments to ceiling. |
| (c) | Exempt Group: | Annual Indexation Adjustments to ceiling. |

03.4.7 Valorisation of Contributions Paid

Valorisation means the weighting to be applied to the contributions paid during one's accumulation period upon which the calculation is carried out before a pension is first issued to a person. Valorisation can be in two ways: either by means of inflation or by means of wages. For the reasons discussed earlier in this Report, valorisation by inflation will have a positive impact on sustainability but a negative impact on adequacy; whilst valorisation by wages will have an inverse affect.

In the White Paper, the Group did not discuss the issue of valorisation even though the models simulated on PROST factored in valorisation. This was an oversight. In the White Paper, the Group adopted valorisation by means of inflation as an integral part of the reform measures proposed.

In the recommendations proposed earlier in this Report the Group has reconsidered its original position that indexation should be solely on the basis of inflation; and thus bereft of any linkages with wages.

In the simulations undertaken for the preparation of this Report, the Group sought to apply this principle on the valorisation mechanism. The results from the simulations lead one to conclude that this is not possible as the impact on the sustainability of the pensions system is negative.

Thus, the Group recommends that the valorisation mechanism should be on the basis of inflation.

Final Recommendation No 38

The Pensions Working Group recommends that the valorisation mechanism should be on the basis of inflation.

03.5 Rendering the Pensions System Sustainable in a Context of Sound Public Finances

The Group in the White Paper reaffirmed the declaration made by the Government in the 2004 budget that a Health Fund is introduced and that part of the Two-Thirds Pension contribution should be channelled to this Fund in order to support the financing of the health system. The rationale behind the Group's position was that there is a strong correlation between aging and health expenditure and thus a channelling of part of one's contribution to the support the financing of the public health service is socially justifiable.

The feedback received by the Group shows that there is concern amongst constituted bodies and individuals on the state of the health sector and it's financing. Most argue that reform in the health area is a necessity and that this reform should have been carried out simultaneously with the reform of the pensions system. Nevertheless, it is pertinent to underline that, in the main, there is disagreement with the recommendation that part of the contribution that people pay for contributory benefits is 'carved out' for the payment of other services – social as well as health.

The argument presented is that in a state of play where the pensions system itself is under threat in terms of adequacy and sustainability it is not acceptable that contributions paid specifically for pensions are used to finance other expenditure – socially justifiable as such expenditure may be.

This issue warrants attention. In the post-consultation work carried out by the Group considerable attention was given towards the importance of designing a balance between adequacy and sustainability. The White Paper was primarily criticised on the basis that whilst it secured sustainability it failed to achieve a decent standard of adequacy – even when the average replacement rates from both the Two-Thirds Pension and the Second Pillar Pension are combined. In part, this criticism is justifiable.

Thus, the Group has attempted various pension reform combinations in the post-consultation work directed to attain a far better average replacement rate whilst at the same time allowing for the channelling of part of the pension contribution to the proposed Health Fund.

The parametric reforms to the Two-Thirds Pension discussed earlier only go a certain extent in alleviating the level of adequacy. In the end adequacy is also dependent on the contribution paid. A channelling of part of the pensions contribution to the Health Fund would require a corresponding increase on the contribution paid on either the Two-Thirds Pension or the Second Pillar Pension. In order to keep increases on the contributions paid either on Two-Thirds and / or Second Pillar Pension to the minimum possible whilst securing a greater level of income from the contributions paid, the Group proposes that:

- (a) The original decision to channel part of the Two-Thirds Pension contribution to the Health Fund – assumed to constitute 2% of the Employee's contribution and 1% of the State Grant in the White Paper – is reconsidered, with the contributions paid to be retained for pension purposes.
- (b) That the % contribution marked for channelling into the Health Fund is 'carved out' in order to enable for the introduction of a mandatory Second Pillar Pension Scheme in a neutral manner. This matter is discussed in section 03.6.11.
- (c) Reaffirms the original decision in the White Paper, that non-contributory benefits should not be paid from the pensions' contributions but should be financed through taxation.

No doubt, the Group is aware that the above recommendations will have fiscal implications on Government in terms of the financing of the health sector and the provision of non-contributory benefits.

The use of pensions contributions to cross-subsidise the cost of the health service and the provision of non-contributory benefits, however, fudges the matter of the financing of pensions, health and non-contributory benefits in the short term as the true state of play is masked. In the long term all three areas will be financially non sustainable – with the adequacy of the service and benefits, however, provided under threat unless the true cost is stated and action to place such health and social services on a sustainable financial footing are taken. In short cross-subsidisation cannot be a long-term solution.

| Original Decision of Principle No 38 |
|---|
| The 2004 budget declaration that health funding should be separated from social security funding and ring-fenced accordingly, and that part of the social security contribution will finance health services should continue to hold. |

| Final Recommendation No 39 |
|---|
| <p>The Pensions Working Group recommends that:</p> <ul style="list-style-type: none">(a) the White Paper recommendation to channel part of the Two-Thirds Pension contribution to the Health Fund – assumed to constitute 2% of the Employee's contribution and 1% of the State Grant – is reconsidered.(b) The % contribution marked for channelling into the Health Fund in the White Paper is 'carved out' in order to enable the introduction of a mandatory Second Pillar Pension Scheme in a neutral manner.(c) reaffirms the original decision in the White Paper, that non contributory benefits should not be paid from the pensions' contributions but should be financed through taxation is reaffirmed. |

The Group proposes that Government should create separate Accounts or Funds for pensions, health, and non-contributory benefits with clear non-subsidised financing mechanisms across them – thereby introducing a framework that allows financing to be transparent, managed, and controlled. Thus the true cost of the service provided will be known at all times, thereby allowing for strategic, targeted and specific action to be taken to introduce efficiencies, effectiveness and economies in the said areas as well as to neutralise deficits or ensure that expenditure is maintained within acceptable and affordable parameters.

It is not within the Terms of Reference of the Group to put forward recommendations in relation to the health sector. Nevertheless, within the context of the recommendations proposed above where revenue collected from contributions paid is retained for pensions purposes and cross-subsidisation is terminated there is, no doubt, a need to review the financing structure of the health service and the non-contributory benefits.

Original Decision of Principle No 39

A ring fenced Account for contribution benefits and pensions, with appropriate transparent governance, is established.

Final Recommendation No 40

The Pensions Working Group recommends that for strategic and effective management of the pensions system there should be no cross-subsidisation from National Insurance contributions to support the financing of health or other social services; with revenue collected to be placed within a ring-fenced Pensions Account.

Further to the above, the reform of the pensions system requires a review of the existing process and the supporting ICT infrastructure. The review should be premised on a number of principles.

First, a lower cost of administration – where-in so far as possible transactions between employers, self-employed and employees should be done electronically to minimise to the extent possible back office costs.

Second, a more efficient and effective mechanism to collect employers and employees contributions. Contributors should not be provided with the ability of deferring payment of contributions unless where specifically indicated in the Report to the Two-Thirds Pension and the Second Pillar Pension.

Third, in so far as it is possible, employers, employees and self-employed should be subject to the same administrative process so that the administration of the scheme is simplified to the extent possible.

Fourth, transparency. The contributor should at any point in time either by electronic, telephone or conventional means be able to access his or her pension account to view the pension balance and how this is expected to perform in the future. The ability for the contributor to view his or her pension account should not be limited solely to the Two-Thirds Pension but also to his or her Second and Third Pillar Pension schemes respectively. This would necessitate a review of the current Social Security Benefits Administration information system (SABS) to allow it to integrate with the systems of financial service providers to attain this holistic personal pension view.

Final Recommendation No 41

The Pensions Working Group recommends that an integral part of the pensions reform is a business, administrative and ICT review of the existing pensions structure directed to: (a) secure a lower cost of administration; (b) attain more efficient and effective revenue collection; (c) achieve simplification; and (d) guarantee transparency.

03.6 Enabling People to Maintain Standards of Living

03.6.1 Introducing the Second Pillar Pension Scheme

The Group in the White Paper proposed a multi-pillared approach for the new pensions system – with the First Pillar consisting of an adequate pension provided by the State; with the Second Pillar consisting of savings made in a private pension by individuals to improve their life style; and a Third Pillar that provides individuals with a choice to save more for their retirement should they wish to do so.

The proposed multi-pillared approach is premised on the following principles. First. The Two-Thirds Pension provided by the State must be sufficiently adequate to allow a person to live well during retirement. An adequate pension, however, does not mean that the pension income would equate to the level of income enjoyed when a person is in employment. Such an expectation is not correct. Thus, the second principle. A person must assume responsibility to increase his or her level of pension income during retirement should he or she wish to maintain a standard of living during retirement which is closer to that the person enjoyed whilst in employment.

Thus, the Group reaffirms its recommendation that a Second Pillar Pension Scheme is introduced in order to allow a person to enhance his or her standard of living.

Original Decision of Principle No 06

The new pensions system should include a Second Pillar Pensions Scheme (SPPS) to increase one's pension income to enhance the standard of living.

Final Recommendation No 42

The Pensions Working Group reaffirms this recommendation.

03.6.2 Introducing the Third Pillar Pension Scheme

The Group also reaffirms its recommendation that the new pensions system should also provide for a Third Pillar Pension Scheme directed to complement the pensions income and thereby securing choice.

Original Decision of Principle No 07

The new pensions system should also provide for a Third Pillar Pensions Scheme (TPPS) which shall be a voluntary option directed to complement the pensions income.

Final Recommendation No 43

The Pensions Working Group reaffirms this recommendation.

03.6.3 Introducing a Regulated Property Pension Fund as a Third Pillar Scheme

It is pertinent to state that during the consultation process recommendations were made for the introduction of a Second Pillar Pension Scheme that would be constituted by means of a Pension Property Fund. The case for this recommendation argues that (a) given the high level of house ownership in Malta; and (b) that a considerable number of individuals already own their own property thereby diminishing the impact of the need to inherit their parents' property to move into an ownership status, owners of property could convert the 'locked-up' capital invested in their house by means of home ownership schemes and thereby significantly supplement their pension income without the need to change consumption patterns.

The Group looked closely into this recommendation and concluded that it would be difficult to introduce Property Pension Funds as an integrated part of the Second Pillar Pension Scheme. Property Pension Funds work on the basis of selling one's house or obtaining a loan on the house whilst continuing to hold occupancy, with the house to be sold upon the death of the owner with the proceedings paying off the capital or loan, with any remaining income bequeathed to the heirs. In essence, what this implies, therefore, is that Property Pension Funds can only work if a person converts his or her property into such a fund in the latter part of one's life – as otherwise the interests accruing on the capital or loan would outstrip by far the income obtained from the house. Moreover, a Property Pension Fund assumes that the person owns the house – a state of play that most people will reach close to their retirement age.

Thus whilst the Group concludes that a Property Pension Fund cannot constitute part of the Second Pillar Pension Scheme it is of the considered opinion that the option for the financial services market to offer Property Pension Funds as a Third Pillar product should be made available. **Supplementary Paper Number 4** titled '**Use of Property for Retirement**' provides a preliminary assessment on Property Pension Funds carried out by the Group.

Final Recommendation No 44

The Pensions Working Group recommends that the financial services market should offer regulated Property Pension Funds as a Third Pillar product.

03.6.4 Identifying the Regulator for the Second and Third Pillar Pension Schemes Respectively

The Group reaffirms its recommendation that the regulation of the Second Pillar and the Third Pillar pension schemes respectively are entrusted to the Malta Financial Services Authority operating under the Special Funds (Regulations) Act in order to attain high standards of governance.

It is proposed that the Malta Financial Services Authority carries out amendments to the said Act to render the Act compliant with EU Directive 2003/41/EC titled 'On the Activities and Supervision of Institutions for Occupational Retirement Provision'. Moreover, the Malta Financial Services Authority should work with the Department for Social Security to ensure that the necessary legislative parameters on the governance of institutions managing social security schemes (which could apply to a mandatory Second Pillar Pension Scheme) as established by Regulation (EEC) No 1408/71 titled 'Application of Social Security Schemes to Employed Persons, to Self-Employed Persons and to Members of their Families Moving within the Community' and Regulation (EEC) No 574/72 titled 'Fixing the Procedure for Implementing Regulation (EEC) No 1408/71' are transposed where so appropriate. One fundamental requirement is discussed under Section 03.6.7 titled 'Safeguarding the Beneficiaries of Second Pillar Pension Schemes'.

Original Decision of Principle No 08

The regulation of the Second Pillar and the Third Pillar pensions scheme should be entrusted to the MFSA operating under the Special Funds (Regulation) Act 2002.

Final Recommendation No 45

The Pensions Working Group reaffirms its recommendation that the regulation and governance of the Second Pillar and the Third Pillar pension schemes respectively are entrusted to the Malta Financial Services Authority operating under the Special Funds (Regulations) Act – with amendments to be made where so appropriate to this Act in terms of EU Directive 2003/41/EC and the Social Security Act in terms of Regulations (EEC) No 1408/71 and 574/72.

03.6.5 The Constitutional Set-up of the Second Pillar Pension Scheme

In terms of the type and nature of Second Pillar Pension Schemes that should be introduced, Hewitt, Bacon and Woodrow Ltd recommend that Defined Benefits schemes should be avoided and a hybrid scheme that incorporates Defined Contribution elements but allows for the pooling of risks is introduced. **Supplementary Paper Number 5** titled '**Second Pillar Pension Schemes**' provides an overview of the different schemes around which a Second Pillar Pension system can be built.

The Group agrees with the recommendation made by Hewitt, Bacon and Woodrow Ltd that the Second Pillar Pension Scheme should not be designed around Defined Benefits schemes. In this regard the Group is uncertain whether the regulator should *a priori* prohibit the introduction of Defined Benefits by providers or allow the market to respond to demand.

The Group's bias is that in the early years leading to the institutionalisation of the Second Pillar Pension Scheme all preventable risks that can undermine confidence in the Second Pillar system should, if so possible, be prevented.

The Group, thus believes that the Malta Financial Services Authority should work with the financial services market to allow for the design of Second Pillar Pension Schemes that will provide most value to the investor with the least risk at the least cost of administration.

In doing so, however, the Group strongly suggests that the contemplation put forward in the White Paper relating to two-tier Second Pillar scheme is positively considered as such a scheme provides a person with the opportunity to personalise his or her scheme beyond the mandatory common requirement without the need to opt for a Third Pillar investment and thus incur additional costs.

Original Decision of Principle No 09

The Second Pillar Pensions Scheme should be established in terms of a common yet flexible scheme basis.

Final Recommendation No 46

Whilst the Pensions Working Group proposes that the Second Pillar Pension Scheme should not be designed around Defined Benefits schemes it recommends that the Malta Financial Services Authority should work with the financial services market to allow for the design of Second Pillar Pension Schemes that will provide most value to the investor with the least risk at the least cost of administration. It further proposes that the consideration put forward in the White Paper for the introduction of a Two-Tier Second Pillar Pension Scheme is positively met as this allows a contributor to personalise his or her scheme beyond the mandatory requirement without the need to opt for a Third Pillar Scheme, and thus incur additional cost.

In the recommendations put forward in the White Paper on the constitutional make-up of the Second Pillar Pensions Scheme the Group adopted the principle of choice across the entire private pillar provision chain: that is, a competitive environment with the individual having the ability to choose whether his or her private pension is through an Occupational Fund or through a scheme entered directly with the provider.

On reflection, the Group has reconsidered its position on this matter. Whilst it continues to believe that the Second Pillar Pensions Scheme provision should be on the basis of competition within the constraints of a tightly regulated market it is advising, at least in the early stages of the Second Pillar Pension Scheme, against the ability of an individual to choose his or her second pillar pension directly from a scheme provider.

The Group is concerned that if its original recommendation is adopted the danger exists, particularly given the lack of knowledge of the market, of individuals making wrong, and therefore painful and costly choices that could jeopardise their pension income through the Second Pillar Pension Scheme. Moreover, the Group fears that a scenario of choice in this regard would see pension scheme providers targetting persons directly so that they select their particular pension brand. This will have two dangers. First, and as has occurred in other countries notably the United Kingdom when private pensions were first introduced, mis-selling. Second, the cost of administration due to a higher cost of advertisement would increase.

In this regard, the Group is of the considered opinion that Second Pillar Pension Scheme, as a first step, should be entered into only through occupational pensions.

Original Decision of Principle No 10

An employee should have the right to choose the provider of the Second Pillar Pensions Scheme.

Final Recommendation No 47

The Pensions Working Group recommends that as a first step the Second Pillar Pension Scheme should be entered into only through occupational pensions schemes. Changes to the Second Pillar Pension Scheme to introduce individual choice should only be embarked upon once the appropriate credibility, trust and maturity of the Scheme is attained.

The Group reaffirms its recommendation that the Second Pillar Pension Scheme will also apply to the self-employed.

Original Decision of Principle No 11

The Second Pillar Pensions Scheme will also apply to the self-employed.

Final Recommendation No 48

The Pensions Working Group reaffirms this recommendation.

03.6.6 Establishing the Parameters for Entry into Second Pillar Pension Scheme Provision

During the discussion process as well as in the formal submissions made to the Group a case is made for the provision of the Second Pillar Pension Scheme to be limited to one private sector service provider operating under the direction of a Board that includes social partners.

The Group does not support this position. First, whilst recognising the limitations of economies of scale given Malta's size, the fact remains that single providers, whether public or private, will create a monopolistic environment. Experience has and continues to show that monopolies fail to provide an ambience that is beneficial to the clients they serve. Thus, the Group continues to be of the considered opinion that a full and competitive private sector environment involving financial services providers, within the parameters of a tightly regulated environment, constitutes the appropriate market basis for the provision of Second and Third Pillar Pension Schemes respectively.

Second, the establishment of a Board that includes social partners will not provide any meaningful assurances to contributors. Good, tight and credible regulation, however, does. People invest their savings in profit related schemes, life endowment policies, and bank accounts because they have confidence in the functioning of a credible and well regulated financial market. In fact, there are no social partners involvement in these areas – nor should there ever be. The same applies for the Second Pillar Pension Scheme.

Original Decision of Principle No 12

Entry into the Second Pillar Pensions Scheme provision by private sector insurance firms must be subject to strict entry and performance criteria that must be met at all times.

Final Recommendation No 49

The Pensions Working Group recommends that fair competition is the best guarantee to a contributor to a Second Pillar Pension Scheme. There should be open involvement of financial service providers in the Second Pillar Pension Scheme within the parameters of strict and tight entry and performance criteria which must be met at all times.

The application of strict and tight entry criteria will assure that no 'fly by night' service providers enter the market; and that only financial service providers which have the appropriate capital, skills, knowledge et al, are accredited by the Regulator to provide Second Pillar Pension Schemes. The performance criteria will seek to ensure that financial service providers will maintain the cost of administration to the minimum possible, that potential for mis-selling is avoided, that full transparency is maintained, and that redress is possible.

Thus, the Group reaffirms the recommendations it made in the White Paper in terms of the criteria that should be upheld for financial services providers to the Scheme. It recommends, however, two changes to these criteria.

First. Whilst the White Paper implies that entry should be on the basis of strong, sound and sustainable financial capital basis, this is not unequivocally spelt out. To ensure clarity, the Group strongly recommends this criterion as an absolute necessity.

Second. In the White Paper the Group proposed that providers should have full time actuaries in employment. On reflection, the Group concludes that the important requirement is for Second Pillar Pensions Scheme providers to make use of actuarial services as against the strict requirement for actuarial staff employment particularly given the specialised nature of the skill and the limited presence of such skills in Malta. Thus, the Regulator, should ensure that firms providing Second Pillar Pension Schemes would have outsourced or contracted out the actuarial input to actuarial firms of repute in the event that they do not opt for employing an actuary.

Final Recommendation No 50

Whilst the Pensions Working Group reaffirms the recommendations made in terms of the criteria for entry and performance it further proposes that (a) strong sound and sustainable financial capital basis is an absolute necessity; and (b) that the criteria for actuarial experts would be considered to be met if such a service is outsourced or contracted out to a Regulator accredited actuarial service provider.

03.6.7 Safeguarding the Beneficiaries of Second Pillar Pension Schemes

The Group reaffirms its recommendation that the Second Pillar Pension Scheme contributions paid by the employer must be strictly separated from the said employer; with the pension fund established as an autonomous 'ring fenced' asset.

Original Decision of Principle No 13

The Second Pillar Pensions Scheme contributions paid by the employer must be strictly separated from the said employer; with the pension fund established as an autonomous 'ring-fenced' asset.

Final Recommendation No 51

The Pensions Working Group reaffirms this recommendation.

During the introduction of the Second Pillar Pension Scheme and until such time as experience is garnered in this area, the Group is of the strong opinion that a common set of principles and limitations should apply to the Scheme structure given the lack of experience, the initial limited economies of scale and the potential limited competition and choice. As knowledge and experience is accrued the regulatory environment in terms of the management of the investment can be modified as appropriate.

In this regard, the Group continues to be of the opinion that whilst the investment management standard should be the 'prudent person principle', this should be complemented by a number of quantitative limitations related to diversification.

Supplementary Paper Number 6 titled '**Investment Principles for Occupational Retirement Schemes**' looks at the limitations that should be introduced. In summary, the Group is proposing limitations relating to investments to be made in equity, and to investments to be made in emerging markets and non-OECD countries to those already introduced under the Special Funds Act.

The argument exists that investments in immovable property provide excellent investment opportunities; particularly given the long term nature of the Second Pillar Pension Scheme – as they add another dimension to asset allocation, enhance the diversification of the portfolio particularly since real estate returns have a low correlation with the returns on equity and fixed income securities. In Malta exists the notion that the value of property never goes down, particularly given the performance of this sector during the last three decades.

The Group, however, is concerned on the placement of local immovable property, at least initially, as part of the Second Pillar Pension Scheme portfolio. It believes that there are various issues that one needs to consider. First. Property prices in Malta are high compared to wages earned and the issue of affordability is fast becoming a sensitive matter. Second. If Second Pillar Pension Schemes choose to invest directly in local property, particularly given the lack of available securities on the local capital market, the real danger exists that the prices of property could easily become over inflated, leading to speculation – with the resultant negative social and economic implications such a situation may give rise to.

The Group is, thus, of the considered opinion that Second Pillar Pension Schemes should not be allowed to invest directly in immovable property, at least not at the outset, given the associated risks. Rather, the Group proposes that initially a cautious approach is adopted and that Second Pillar Pension Schemes should limit their exposure to the property market indirectly – that is through investment in publicly traded equity and / or fixed income securities of companies engaged in the real estate such as property management and property financing companies.

It is also argued that the Second Pillar Pension Schemes should be invested in Malta, with potentiality for overseas investment restricted. This school of thought is based on the premise that such investment would help to propel economic growth in Malta. The issue of investing in Malta is important because it can result in significant economic implications.

Two matters must be considered. The first is the size of the market in Malta. The Quarterly Review of the Central Bank of Malta indicates:

- (a) The total market capitalisation of the Malta Stock Exchange is approximately Lm800 million.
- (b) Over Lm550 million of this comprises of Government of Malta securities and bonds.
- (c) Of the Lm250 million in equities, over Lm150 million is invested in the banking sector and most of the remaining Lm100 million is concentrated in the telecommunications and hotel sectors.

This high level of concentration means that the ability to diversify investments within Maltese securities and equities is limited. An approach that seeks the investment of the Second Pillar Pension Funds in Malta will involve the following interdependent risks:

- (a) The risk of the poor performance of the Maltese economy which will impact the returns on the investment.
- (b) The risk of low investment performance in Maltese equity and a worsening credit rating investment performance in Maltese bond investments which will lead to lower Second Pillar Pension Scheme benefits.
- (c) The artificial inflation of the prices of local assets to unrealistic levels.

The second relates to the purpose of a Second Pillar Pensions Scheme fund. The sole purpose of a fund is to generate the maximum return possible to the person investing for his or her pension. If the maximum return is generated by investing the Second Pillar Pensions Scheme fund overseas than it should, and must, be invested outside of Malta. Compromising on this fundamental objective to leverage the Second Pillar Pensions Scheme fund as a stimulus for local economic growth could result in a lower pension return to a person investing his or her savings for an improved pension income.

Thus, the Group is of the considered opinion that the Second Pillar Pension Scheme funds should be invested in those markets which will render the highest return possible within the constraints of the diversification criteria discussed earlier. Should the Government decide to establish a diversification limit that stipulates a maximum % of the Second Pillar Pension Scheme funds that is to be invested in Malta, the Group urges that the maximum % set should be at a fairly low level.

It is pertinent to add, however, that restricting investment to Malta may not be permissible under EU rules on the free movement of capital as enshrined in the EU Treaty.

Original Decision of Principle No 14

The Second Pillar Pensions Scheme should be managed on the prudent-person principle together with (a) the inclusion of specified limitations to determine the diversification parameters of the investment portfolio, and (b) restrictions to limit the private sector insurance firm managing the portfolio to invest in its own assets or subsidiaries.

Final Recommendation No 52

The Pensions Working Group reaffirms its recommendation that the Second Pillar Pensions Scheme should be managed on the prudent-person principle together with the inclusion of specified limitations to determine the diversification parameters of the investment portfolio which in addition to those already present under the Special Fund (Regulation) Act 2002 should include:

- (a) Limitations on investments in equities to a maximum limit of 35%.
- (b) Limitations on investments in emerging markets and non-OECD countries to a maximum limit of 30%.
- (c) Inability to invest directly in immovable property though investment in publicly traded equity and / or fixed income securities of companies engaged in the real estate such as property, management and property financing companies should be permitted.

The Group further recommends that the Second Pillar Pension Scheme funds should be invested in those markets that will render the highest return possible to the investor within the constraints of the prudent person principle and the proposed diversification criteria.

In terms of implementing proposals (a) and (b) of Recommendation Number 52 above, however, a distinction must be made between the provision of international retirement pension schemes through the Malta Financial Services Authority and the introduction of the Second Pillar Pensions Scheme as an integral component of the local pensions system. The afore mentioned EU Directive on occupational schemes states that Member States cannot impose any limitations on equity investments falling under the said Directive.

Thus in order to secure the introduction of the said diversification parameters deemed necessary in the start-up period of the Second Pillar Pension Scheme, whilst at the same time assure that Malta's ability to participate in the international provision of such schemes is not undermined, the Group recommends that these restrictions are introduced at the scheme level under the afore mentioned Social Security Regulation (EEC) 1408/71; with the Malta Financial Services Authority retaining regulation over the scheme.

Final Recommendation No 53

The Pensions Working Group recommends that the implementation of parameters (a) and (b) proposed in Recommendation No 52 should be introduced in terms of Regulation (EEC) 1408/71 under the regulation of the Malta Financial Services Authority in order to assure Malta's ability to participate internationally in the provision of Second Pillar Pensions Schemes.

It is pertinent to underline that Second Pillar Pension funds can be constituted as 'fund of funds'. In essence, this means that funds may be invested in other funds that can carry out direct investment. As a consequence of this, the Group recommends that in the event of 'fund of funds' invested in overseas investments the afore mentioned criteria will not apply in so far that the providers of such overseas 'fund of funds' investment are accredited by the Malta Financial Services Authority.

Final Recommendation No 54

The Pensions Working Group recommends that in relation to investment in overseas 'fund of funds' criteria (a) and (b) proposed in Recommendation No 52 will not apply in so far that the providers of such overseas 'fund of funds' investment are accredited by the Malta Financial Services Authority.

The Group reaffirms its recommendation that measures to provide for financial protection to Second Pillar Pensions Scheme contributors and pensioners against fraud, mis-use, insolvency, etc, must be introduced, and should be designed in a manner that place the least burden on stakeholders. It is pertinent to note, that the Group in the White Paper had mooted the possibility of creating a compensation fund as one of the safeguards to be introduced.

It is thus proposed that the Government tasks the Malta Financial Services Authority to draw up the protection mechanisms and safeguards that should be introduced in tandem with the launch of the Second Pillar Pension Scheme.

Original Decision of Principle No 15

Measures to provide for financial protection to Second Pillar Pensions Scheme contributors and pensioners against fraud, mis-use, insolvency, etc, must be introduced, and should be designed in a manner that place the least burden on stakeholders.

Final Recommendation No 55

The Pensions Working Group reaffirms this recommendation and further proposes that the Government tasks the Malta Financial Services Authority to draw up the protection mechanisms and safeguards that should be introduced in tandem with the launch of the Second Pillar Pension Scheme.

03.6.8 Assuring Portability of Second Pillar Pension Schemes and Safeguarding Against Opt-Outs

The Group reaffirms the recommendation that Second Pillar Pension Schemes should be portable and that a person should not have the option to liquidate the fund.

Original Decision of Principle No 16

Funds under the Second Pillar Pensions Scheme should be portable and a person should not have the option to liquidate the fund.

Final Recommendation No 56

The Pensions Working Group reaffirms this recommendation.

03.6.9 Rewarding and Incentivising Savings for Retirement

The Group is strongly of the opinion that savings into a Second Pillar Pensions Scheme should be incentivised as savings have a positive impact on the aggregate wealth of the nation. The Group has initiated a study to determine the type of tax incentives to be applied. The Group regrets to state that this study could not be completed prior to the drawing up of this Report. This Report is targeted for completion in November 2005.

The Group recommends that the Government should not make any decisions on the incentives to be adopted on the Second Pillar Pension Scheme until the commissioned Supplementary Paper on this matter is presented.

Original Decision of Principle No 17

The annual contributions into a Second Pillar Pensions Scheme should not be taxed on an annual basis. A maximum tax, established at a fixed percentage rate, should be paid upon the maturity of the Scheme.

Final Recommendation No 57

Whilst the Pensions Working Group supports the economic argument that increased savings have a positive impact on the aggregate wealth of the nation and thus Government should provide fiscal incentives on the Second Pillar Pension Scheme, it recommends that the Government should not make any decisions on the incentives to be adopted until the Supplementary Paper on this matter is presented.

Furthermore, the Group continues to be of the opinion that incentives should not be restricted to a mandatory Second Pillar Pension Scheme but should incorporate a voluntary Second Pillar as well as Third Pillar pension schemes.

Original Decision of Principle No 24

The annual contribution to the Third Pillar Pensions Scheme should be non-taxed up to a capped limit. The income derived on the maturity of the Third Pillar Pensions Scheme will be subject to income tax based on the individual's PAYE rate.

Final Recommendation No 58

Whilst the Pensions Working Group believes that incentives should incorporate voluntary Second Pillar and Third Pillar pension schemes respectively, it recommends that the Government should not make any decisions on the incentives to be adopted until the Supplementary Paper on this matter is presented.

03.6.10 Managing Benefits Upon Maturity of a Second Pillar Pension Scheme

The Group reaffirms its recommendation that the bulk of the Second Pillar Pension Scheme upon maturity should be taken in the form of an annuity. More specifically, the Group recommends that upon maturity the pension should be provided as follows:

| | |
|-----|--|
| 20% | Maximum that a person will be able to convert as a lump sum upon maturity. |
| 80% | Minimum that a person will be able to convert as a monthly annuity. |

In essence, the above means that whilst a person can opt for the pension to be converted in its totality as a monthly annuity, the maximum amount that can be converted into a lump sum upon maturity would be limited to 20% of the investment saved. This measure is proposed in order to avert the potential danger that a person consumes the lump sum received from a matured Second Pillar Pension Scheme on conspicuous consumption and thereby ends with a poorer replacement rate as the income is not retained for pension purposes.

Original Decision of Principle No 18

The Second Pillar Pensions Scheme should upon maturity allow for the option to convert a maximum established part of the individual matured pension fund into a lump sum and with the bulk placed as an annuity to provide for a steady annual pension income over the lifetime of the pensioner.

Final Recommendation No 59

The Pensions Working Group recommends that 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 as a monthly annuity.

03.6.11 Implementing the Second Pillar Pension Scheme

As mentioned in the introductory part of this Report, the consultation process and feedback received from the formal submissions show that there is universal agreement with the introduction of a Second Pillar Pension Scheme. Nevertheless, the majority is of the opinion that the Second Pillar Pension Scheme should be introduced on a voluntary basis with the Government providing the necessary educational and information campaigns as well as the fiscal incentives to encourage people to save.

The debate for compulsory or mandatory savings on the one hand, and for voluntary savings on the other stand at separate axis. The arguments in favour of mandatory savings stem from the concern that people psychologically tend to be concerned with contemporary issues related to particular phases of their lives. The future is seen as too distant and hence should be faced only in due course. The danger stems from the real possibility that people will not save for their retirement and, hence, will face financial constraints upon retirement when they will realise that the pension income will not allow them to maintain the standard of living they had become accustomed to whilst in employment. It is pertinent to underline that concerns on the low take-up to private pensions exist in countries where a voluntary Second Pillar Pension Scheme was introduced.

Arguments against a mandatory Second Pillar Pension Scheme have primarily two origins. First, by mandating savings in a Second Pillar Pension Scheme the choice available to a person to choose the financial or investment instrument that one may feel is most appropriate for one's particular circumstances is negated. Second, it is also argued that a mandatory introduction of a Second Pillar Pension Scheme will, on the one hand, negatively impact the disposable income of the individual, and on the other hand, increase the costs to industry and thus impact Malta's competitiveness.

In determining a way forward on the introduction of the Second Pillar Pension Scheme the two but separate philosophies need to be weighed carefully. No doubt the impact on disposable income will both affect consumption patterns and affect the multiplier effect on the local economy. Nevertheless it is pertinent to emphasise that saving in a Second Pillar Pension Scheme is not a tax instrument – savings mean the deferment of part of one's consumption today to increase one's consumption during retirement. In essence, therefore, savings for pension purposes will smoothen the consumption pattern during a person's lifetime whilst ensuring that a person will have an income beyond that provided by the State pension. It should also be noted that a pensioner's input into the local economy is high. The consequences of an aging population with far less income to spend would be more negative onto the local economy than measures introduced today to defer part of one's income, and hence consumption, to save to increase one's pension income, and hence increase one's consumption pattern, during retirement.

Malta is currently going through a restructuring process within all sectors of the economy. Stable macro-economic policy demands a rationalisation of government expenditure to ensure that government expenditure is directed to increase productivity and capital investment. The private sector, on the other hand, too must introduce micro economic policies to allow it to face the threat of globalisation. A direct consequence of the restructuring process taking place is a slower pace of economic growth until such time the transition is completed.

In this regard, the Group is concerned that the introduction of a mandatory Second Pillar Pensions Scheme today that will demand from employers payment of a new saving contributions into the Second Pillar Pensions Scheme would add additional pressure at a time when micro economic reform is important.

The Group is thus of the considered opinion that the Second Pillar Pension Scheme is initially introduced mandatorily in a neutral manner, and subsequently phased incrementally.

Original Decision of Principle No 19

The Second Pillar Pensions Scheme should be introduced on a mandatory basis.

Final Recommendation No 60

The Pensions Working Group recommends that the Second Pillar Pension is initially introduced in a neutral manner and subsequently phased incrementally.

The issue, therefore, becomes that of determining the timing of when the mandatory Second Pillar Pension Scheme is introduced. Should it be immediate? Can it be deferred – and what is the time window for different? How will it be introduced initially in a neutral manner?

In addressing the above questions it is pertinent to underline that pensions reform is a long term process. Impacts of reform measures will, according to macro-economic pensions theory, take at least 15 years to permeate. Thus, the expected issues with the current pensions system cannot be resolved when their negative impacts start being felt.

In order to achieve the neutral impact of a Second Pillar Pension Scheme the Group recommends that the 2% contribution originally earmarked to be channelled to the Health Fund is in fact 'carved out' but channelled, instead, into a mandatory Second Pillar Pensions Scheme.

The adoption of this recommendation will, in the immediate term, have a neutral effect both on the adequacy and sustainability of the pensions system. It will, however, allow for the attainment of a fundamental cornerstone of the reform of the pensions system without causing detrimental affects on people's disposable income and on employers' competitiveness. More specifically, the Group proposes the following:

- (a) The Second Pillar Pensions Scheme is introduced mandatorily as at 1st January 2007.
- (b) The savings contribution to the Second Pillar Pensions Scheme will be 'carved out' from the Class I contributions as follows:
 - 1% from the Class I Employee's contribution
 - 1% from the Class I Employers' contribution.
- (c) A similar 1% will be 'carved out' from the Class II self-employed person contributions.
- (d) The contributions ceiling on the Second Pillar Pensions Scheme for the 'carved out' contribution % referred to in (b) and (c) above will be identical to the Maximum Pensions Income ceiling of the Two-Thirds Pension.
- (e) There will be no tax incentive on the 'carved out' contribution %.

Original Decision of Principle No 21

The Second Pillar Pensions Scheme should be introduced in a transitional manner; with the SPPS to be first introduced on a voluntary basis as from 1st January 2006.

Final Recommendation No 61

The Pensions Working Group recommends that the neutral introduction of a mandatory Second Pillar Pension Scheme proposed in Recommendation 60 is achieved by 'carving out' 1% Employer and 1% Employee from the Class I contribution and a 1% Self-Employed from the Class II contribution respectively into the Second Pillar Pension Scheme as from 1st January 2007.

In tandem with the above, the Government through the Malta Financial Services Authority should work with the financial services market to introduce Second Pillar Pensions Schemes as early as possible in 2006 that will allow persons to invest on voluntary basis over and above the 'carve out' from their Class I contribution. The voluntary Second Pillar Pension Schemes should be designed in a manner that allows people to transfer their voluntary schemes into their mandatory Second Pillar Pension Schemes at no administrative cost and without complexities when the Government decides to increase the mandatory contribution beyond the proposed 'carve out'.

Final Recommendation No 62

The Pensions Working Group recommends that whilst voluntary Second Pillar Pension Schemes should be introduced as early as possible in 2006 these should be designed in a manner that will allow investors to integrate such schemes in the mandatory Second Pillar Pension Scheme at no administrative cost and without complexities should Government decide in the future to increase the mandatory contribution to the Second Pillar Pension Scheme beyond the proposed 'carve out' contribution.

As stated above the proposed 'carve out' from the Class I and Class II contributions to the mandatory Second Pillar Pension Scheme will in the immediate term have a neutral effect on the sustainability and adequacy of the pensions system.

Simulations, however, show that an improved average replacement rate will be reached if the mandatory contribution by employers and employees to the Second Pillar Pension Scheme is increased to, at least, 4% respectively. The Group is of the opinion that the increase of the mandatory contribution to the Second Pillar Pension scheme beyond the proposed 'carve out' contribution % should only take place when the economy starts to enjoy sustained growth.

In designing the base line model to enable the Group to carry out various simulations of permutations for reform, the Group assumed that the economy will reach a growth of 3% in 2011 which would increase to 4% by 2025 before leveling off at 2.5% to account for economic cycles for the remainder of the period under evaluation.

This assumption is based on macro-economic theory that economies perform on a cyclical basis and that growth follows once economic restructuring at both the macro and micro level takes place. In the event that the economy will behave in accordance with the macro-economic assumptions taken, the Group suggests the following incremental approach towards increasing the mandatory Second Pillar contribution to 4%:

| | |
|------|--|
| 2011 | +1% Employers and +1% Employees and +1% Self Employed |
| 2020 | +1% Employers and +1% Employees and +1% Self Employed |
| 2025 | +1% Employers and +1% Employees and +1% Self Employed. |

It should be noted that in the White Paper, the Group had modelled the Second Pillar contributions on the March 2004 World Bank Report recommendations of 2% up to 2024 and of 5% from 2025 onwards for employers and employees respectively – bringing the total amount of contributions to be paid between the Two-Thirds Pension and the Second Pillar to 12% up to 2024 and 15% from 2025 onwards for employers and employees respectively. The recommendations proposed in this Report would bring the combined contributions to 11% in 2012, 12% in 2020, and 13% in 2025 for both employers and employees respectively.

Economies, however, do not necessarily behave as predicted – for the better or for the worse. The recommendation presented in this Report is based on the knowledge and information available today and on the basis of results of the models simulated with the context of intelligent assumptions. Thus, the Group is of the considered opinion that the ultimate decision of whether the mandatory contribution to the Second Pillar Pension Scheme should increase to 4% by employees and employers respectively and how the increase is staggered should take place only following the carrying out of the proposed periodic Five Year Structured Reviews.

Original Decision of Principle No 23

Indications are that a mandatory Second Pillar Pensions Scheme should be in place by 2010. Government should take all necessary action to establish the appropriate mechanisms to enable the introduction of the Second Pillar Pensions Scheme by 2010. Nevertheless, the Government should in 2009 undertake an assessment to determine whether the prevailing conditions at that point in time are such that necessitate the mandatory introduction of the Second Pillar by 2010.

Final Recommendation No 63

The modelling carried out by the Pensions Working Group shows that on the basis of the macro-economic assumptions taken the mandatory contribution to the Second Pillar Pension should increase to 4% by employers and employees respectively by 2025.

The Group recommends that a conclusive decision on the quantum, the timing of initiating the increase over and above the proposed 'carve out' contribution, and the phasing of the said increase should take place only following the carrying out of the periodic Five Year Structured Reviews.

Furthermore, the Group believes that the ceiling upon which mandatory contributions are to be paid should be separate from the Maximum Pension Income ceiling upon which the Two-Thirds Pension is calculated.

In this regard, the Group recommends that a Maximum Salary Limit of Lm15,000 is established for contributions to the Second Pillar Pension Scheme. The Maximum Salary Limit will only be applied once the Government takes the decision to increase the mandatory Second Pillar contribution beyond the proposed contribution 'carve out'.

The indexation of the Maximum Salary Limit should be similar to that applied to the Maximum Pension Income ceiling discussed earlier.

Final Recommendation No 64

The Pensions Working Group recommends that a Maximum Salary Limit of Lm15,000 is established as the ceiling for mandatory contributions to the Second Pillar Pension Scheme subject that this ceiling does not apply for the proposed contribution carve out from Class I and Class II contributions; with indexation to be similar to that adopted for the Maximum Pension Income ceiling.

The Group reaffirms its recommendation that persons who today voluntarily made decisions to invest in life endowment or unit-linked policies that are subject to an annual premium should be provided with the option to decide whether they wish to lock such schemes for pension purposes.

In the event that people decide to lock such policies for pension purposes than the premiums paid on the said policy should be considered to constitute part or all of their mandatory contribution to the Second Pillar Pension Scheme. A decision in this regard would mean that upon the maturity of the policy the funds would not be accessible to the individual but rather would be transferred to the individual's Second Pillar Pension Scheme. Designing this policy instrument in this manner should negate any concerns relating to expensive exit fees that an individual may face in the event a person opts out of such a scheme to finance the Second Pillar pension contribution or to the potential disruption to providers of such financial services.

The impact of a policy decision in this regard should not be underestimated. Data collected as at 31st December 2003 by the Malta Financial Services Authority shows that there are 87,376 policies issued of which 85% are not pledged with banks.

Original Decision of Principle No 20

MFSA and Government will work with private sector financial firms to encourage them to introduce a scheme that allows owners of life endowment and profits related policies to convert such policies into the SPPS.

Final Recommendation No 65

The Pensions Working Group reaffirms its recommendation that holders of life endowment policies or unit-linked policies that are subject to annual premiums should be provided with the option to lock such policies for pension purposes with the premium paid meeting part or all of their mandatory contributions to the Second Pillar Pension Scheme subject to the condition that upon maturity the funds are transferred to the Scheme.

Hewitt, Bacon and Woodrow Ltd agree with the recommendation made in the White Paper that the application of the mandatory payment of the contribution to the Second Pillar Pension System should be for persons aged 45 years on its introduction – that is the Switchers Group. The 45 year limit provides a twenty year period assuming a 65 year retirement age, which is deemed to be the minimum necessary for a person to build an adequate savings capital in the Second Pillar Pension Scheme.

The Group thus reaffirms its original position that the introduction of the mandatory Second Pillar Pension Scheme as proposed earlier in this Report should be applicable to the Switchers group.

Nevertheless, people who are 46 years or older should be provided with the opportunity to choose whether they wish to form part of the Second Pillar Pension Scheme subject to the condition that once a person decides to opt in one would not be able to opt out.

Final Recommendation No 66

The Pensions Working Group reaffirms its recommendation that the introduction of the mandatory Second Pillar Pension Scheme as proposed earlier in this Report should be applicable for the Switchers group; with people over 46 years of age to be provided the opportunity to opt in subject to no opt out.

**Forecasted Impacts of the Proposed Reform to the Pensions
System**

Chapter 04

The Pensions Working Group in determining the final recommendations that collectively constitute the proposed reform to the pensions system modelled a considerable number of reform scenarios. This Chapter will for ease of reference compare the proposed reform model with two other scenarios: (a) a scenario of 'No Reform'; and (b) the White Paper scenario. The results of some of the other reform scenarios modelled by the Group are shown in **Appendix III**.

As stated in Chapter 01 of this Report, following the conclusions of the Economic Impact Assessments, the macro-economic assumptions adopted for the post-consultation studies are more conservative than that applied in the modelling for the White Paper. It is pertinent to state that in order to allow for a consistent yardstick for comparative purposes both the 'no reform' and White Paper scenarios are now modelled on the new macro-economic assumptions.

The important factors upon which a comparison of the behaviour of the proposed reform model with the two other models should be made are:

- (a) **Average Replacement Rate:** This will show the pension income in comparison to wages. In essence this determines **adequacy**. The average replacement rate is shown on two levels: the Two-Thirds Pension and the Second Pillar Pension.
- (b) **Deficit to GDP:** This will show the deficit of the pensions system in proportion to the GDP in percentage points. In essence this determines **sustainability**. It is pertinent to underline that in accordance to macro-economic pensions theory the State Grant is not factored in the calculation of the deficit

04.1 Impact on Adequacy

Table 05 below shows how adequacy, in terms of the average replacement rate demonstrated in % points, will be impacted as a result of (a) the proposed reform of the pensions system; (b) a 'no reform' scenario; and (c) a reform scenario based on the White Paper recommendations.

The average replacement rate for the Switchers group, that is those people who will be 45 years of age and below in January 2007 and who will be exposed to the full impacts of the reform, is maintained at practically around the 40% level for the period under review. It dips to 38.6% at the end of the period of the review process. This is a consequence of the staggered and phased implementation of the contribution to be paid on the Second Pillar Pension Scheme.

The average replacement rate of the pensions system under the proposed reform model compares positively against a scenario of 'no reform' where the average replacement rate would fall to 21.2% in 2040 and 14.1% in 2050. It also compares positively against the White Paper reform scenario where the average replacement rate would fall to 28.8% in 2040 and 24.0% in 2050.

Table 05: Impact on Average Replacement Rate of Proposed Reform, 'No Reform', White Paper Reform

| Reform Model | Replacement Rate | | | | | | | | | | |
|-----------------------|------------------|------|------|------|------|------|------|------|------|------|------|
| | 2007 | 2013 | 2015 | 2020 | 2025 | 2027 | 2030 | 2035 | 2040 | 2045 | 2050 |
| Switcher | | | | | | | | | | | |
| Two-Thirds Pension | | | | | | 43.3 | 41.0 | 37.3 | 37.5 | 33.3 | 29.4 |
| Second Pillar Pension | | | | | | 4.5 | 4.9 | 5.8 | 7.0 | 8.1 | 9.2 |
| Total | | | | | | 47.8 | 45.9 | 43.1 | 44.5 | 41.4 | 38.6 |
| Transitional | | | | | | | | | | | |
| Two-Thirds Pension | | | 57.7 | 53.7 | 46.3 | | | | | | |
| Second Pillar Pension | None | | | | | | | | | | |
| Total | | | 57.7 | 53.7 | 46.3 | | | | | | |
| Exempt | | | | | | | | | | | |
| Two-Thirds Pension | 53.3 | 58.3 | | | | | | | | | |
| Second Pillar Pension | None | | | | | | | | | | |
| Total | 53.3 | 58.3 | | | | | | | | | |

| | 2007 | 2013 | 2015 | 2020 | 2025 | 2027 | 2030 | 2035 | 2040 | 2045 | 2050 |
|--------------------------|------|------|------|------|------|------|------|------|------|------|------|
| 'No Reform' Model | | | | | | | | | | | |
| Switcher | | | | | | | | | | | |
| Two-Thirds Pension | | | | | | 34.9 | 31.0 | 25.5 | 21.2 | 17.4 | 14.1 |
| Second Pillar Pension | None | | | | | | | | | | |
| Total | | | | | | 34.9 | 31.0 | 25.5 | 21.2 | 17.4 | 14.1 |
| Transitional | | | | | | | | | | | |
| Two-Thirds Pension | | | 50.6 | 45.0 | 37.7 | | | | | | |
| Second Pillar Pension | None | | | | | | | | | | |
| Total | | | 50.6 | 45.0 | 37.7 | | | | | | |
| Exempt | | | | | | | | | | | |
| Two-Thirds Pension | 53.3 | 58.4 | | | | | | | | | |
| Second Pillar Pension | | | | | | | | | | | |
| Total | 53.3 | 58.4 | | | | | | | | | |

| | 2007 | 2013 | 2015 | 2020 | 2025 | 2027 | 2030 | 2035 | 2040 | 2045 | 2050 |
|--------------------------|------|------|------|------|------|------|------|------|------|------|------|
| White Paper Model | | | | | | | | | | | |
| Switcher | | | | | | | | | | | |
| Two-Thirds Pension | | | | | | 38.8 | 33.5 | 27.0 | 22.0 | 17.8 | 14.4 |
| Second Pillar Pension | | | | | | 3.9 | 4.2 | 5.4 | 6.8 | 8.3 | 9.7 |
| Total | | | | | | 42.7 | 37.7 | 32.4 | 28.8 | 26.1 | 24.1 |
| Transitional | | | | | | | | | | | |
| Two-Thirds Pension | | | 54.0 | 48.6 | 42.1 | | | | | | |
| Second Pillar Pension | | | 0 | 0 | 0 | | | | | | |
| Total | | | 54.0 | 48.6 | 42.1 | | | | | | |
| Exempt | | | | | | | | | | | |
| Two-Thirds Pension | 53.3 | 55.4 | | | | | | | | | |
| Second Pillar Pension | 0 | 0 | | | | | | | | | |
| Total | 53.3 | 55.4 | | | | | | | | | |

Table 06 comparatively demonstrates the impact of the proposed reform to the pensions system on the pensions average replacement rate against a scenario of a reform based on the White Paper recommendations. It is clearly evident from the Table that the reforms proposed in this Report attain a higher average replacement rate for the Two-Thirds Pension than that reached by the White Paper.

This is the result of primarily two of the measures proposed in this Report. The first is the recommendation to raise the Maximum Pension Income ceiling to Lm9,000, as from 2007, for the Switchers group. Thus, the Two-Thirds Pension will now result in a maximum pension of Lm6,000 as against Lm4,500. It is pertinent to underline that the contributions paid by the Switchers group will now be to a maximum of Lm9,000.

The second is the introduction of an indexation mechanism to (a) the Minimum Pensions Guarantee ceiling, (b) the post-retirement pensions income, and (c) the Maximum Pension Income ceiling that is primarily biased towards wages as against total linkage to inflation as proposed in the White Paper.

The strengthening of the average replacement rate under the proposed reform to the pensions system is strongly correlated to the afore mentioned two measures. A reduction in the levels set for the Maximum Pensions Income ceiling and the wages element in the indexation mechanisms will negatively impact the average replacement rate.

The Second Pillar pension initially performs better than under the White Paper reform model. This is a consequence of the introduction of the Second Pillar Pension in a mandatory manner as from 2007 together with the proposed 'carve out' from the Class I and Class II contribution. Over time, however, the Second Pillar Pension will perform at a lower rate than under the White Paper reform model. This is a consequence of (a) the reduction in the Second Pillar Pension contribution from 5% to 4% and (b) a slower phased implementation of the increases to the Second Pillar Pension contribution.

Table 06: Comparative Impact on Adequacy: Proposed Reform vs White Paper Reform

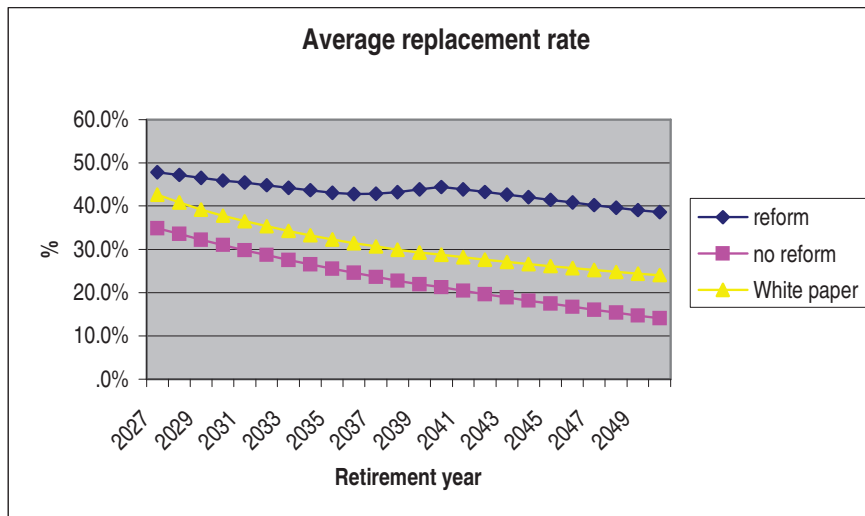
| | 2007 | 2013 | 2015 | 2020 | 2025 | 2027 | 2030 | 2035 | 2040 | 2045 | 2050 |
|-----------------------|------|------|------|------|------|------|------|-------|-------|-------|-------|
| Switcher | | | | | | | | | | | |
| Two-Thirds Pension | | | | | | +4.5 | +7.5 | +10.3 | +15.5 | +15.5 | +15 |
| Second Pillar Pension | | | | | | +0.6 | +0.7 | +0.4 | +0.2 | -0.2 | -0.5 |
| Total | | | | | | +5.1 | +8.2 | +10.7 | +15.7 | +15.3 | +14.5 |
| Transitional | | | | | | | | | | | |
| Two-Thirds Pension | | | +3.7 | +5.1 | +4.2 | | | | | | |
| Second Pillar Pension | | | 0 | 0 | 0 | | | | | | |
| Total | | | +3.7 | +5.1 | +4.2 | | | | | | |
| Exempt | | | | | | | | | | | |
| Two-Thirds Pension | 0 | +2.9 | | | | | | | | | |
| Second Pillar Pension | 0 | 0 | | | | | | | | | |
| Total | 0 | +2.9 | | | | | | | | | |

Table 07 below comparatively demonstrates the impact of the proposed reform to the pensions system on the average replacement rate against a scenario of 'no reform'. Given that the reforms proposed in this Report provide a higher average replacement rate than the reforms originally proposed in the White Paper, it naturally follows that the impacts when compared to a 'no reform' scenario are also positive.

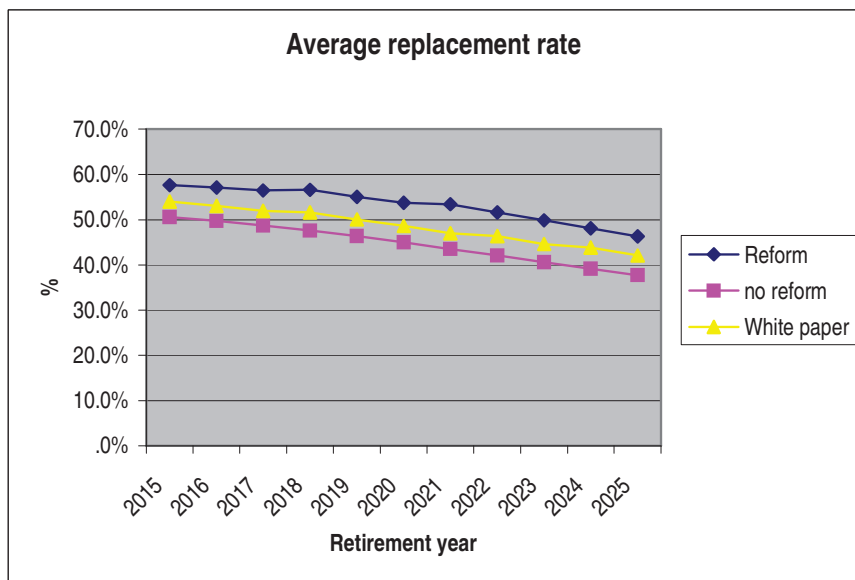
Table 07: Comparative Impact on Average Replacement Rate: Proposed Reform vs 'No reform'

| | 2007 | 2013 | 2015 | 2020 | 2025 | 2027 | 2030 | 2035 | 2040 | 2045 | 2050 |
|-----------------------|------|------|------|------|------|-------|-------|-------|-------|-------|-------|
| Switcher | | | | | | | | | | | |
| Two-Thirds Pension | | | | | | +8.4 | +10 | +11.8 | +16.3 | +15.9 | +15.3 |
| Second Pillar Pension | | | | | | +4.5 | +4.9 | +5.8 | +7.0 | +8.1 | +9.2 |
| Total | | | | | | +12.9 | +14.9 | +17.6 | +23.3 | +24.0 | +24.5 |
| Transitional | | | | | | | | | | | |
| Two-Thirds Pension | | | +7.1 | +8.7 | +8.6 | | | | | | |
| Second Pillar Pension | | | | | | | | | | | |
| Total | | | +7.1 | +8.7 | +8.6 | | | | | | |
| Exempt | | | | | | | | | | | |
| Two-Thirds Pension | 0 | -0.1 | | | | | | | | | |
| Second Pillar Pension | | | | | | | | | | | |
| Total | 0 | -0.1 | | | | | | | | | |

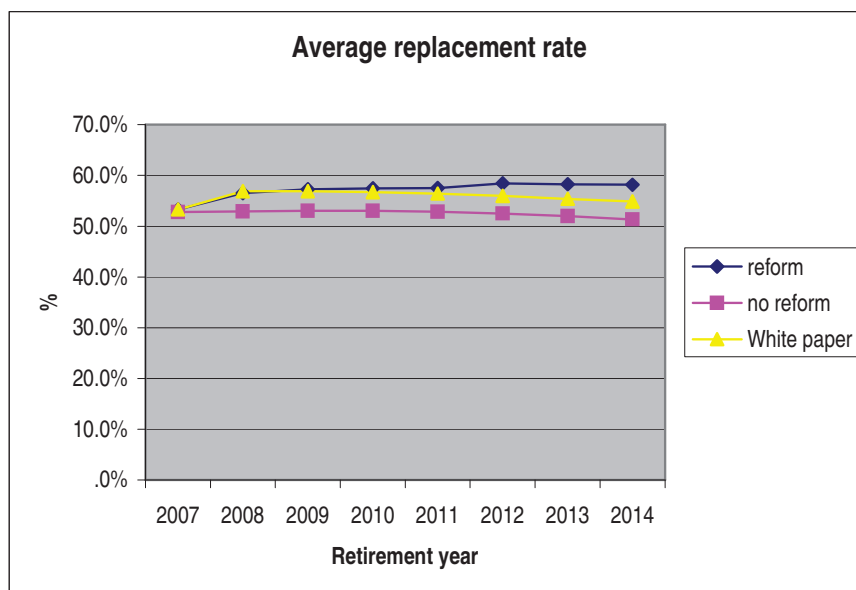
Graph 02 below compares the performance of the average replacement rate of the Switchers group under the three scenarios.



Graph 03 below compares the performance of the average replacement rate of the Transitional group under the three scenarios.



Graph 04 below compares the performance of the average replacement rate of the Exempt group under the three scenarios.



04.2 Impact on Sustainability

Table 08 below shows the % of the pensions deficit to GDP under (a) the reforms proposed in this Report; (b) the White Paper reforms; and (c) a 'no reform' scenario.

The results show that the deficit will for the period under review increase by (0.5%) of the GDP when compared to the White Paper reform model. This result is not surprising given that the proposed reform model has improved considerably the average replacement rates. In the opinion of the Group this marginal increase in the deficit is a relevant price to pay for the improved average replacement rates achieved under the proposed reform model.

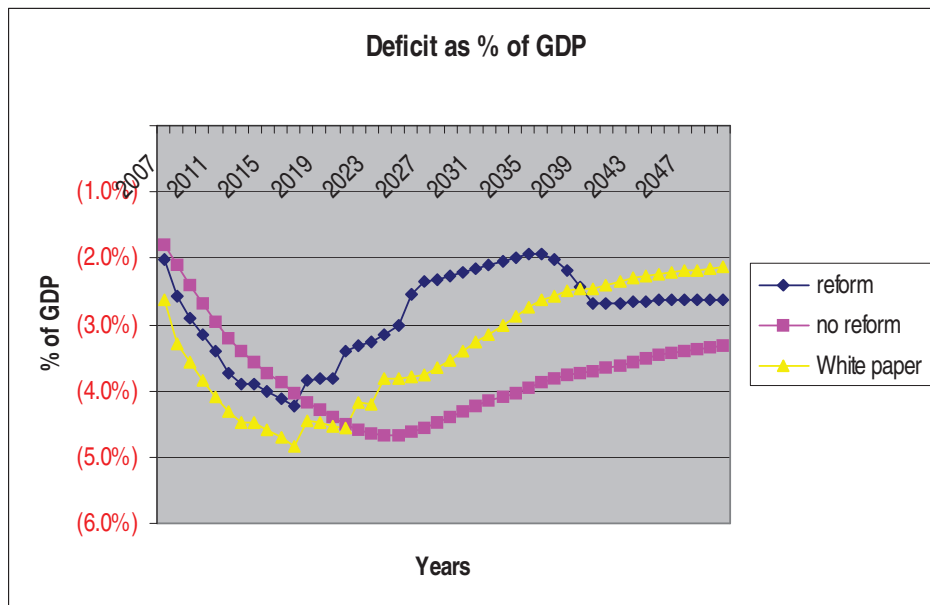
As with the White Paper reforms, the deficit under the newly proposed reforms will increase in the period between 2007 and 2020 before it starts improving and subsequently stabilising around 2.5% towards the latter part of the period under review. This is a direct consequence of the recommendation proposing the carving out of 2% of Class I contributions (1% employer and 1% employee) and 1% of Class II contributions to enable for the introduction of the Second Pillar Pension in a neutral manner as from 2007.

The Group concludes that the proposed reform model with a closing deficit of (2.6%) to GDP is sustainable and does render a far more improved average replacement rate than that generated by the White Paper reform model.

Table 08: % of Deficit to GDP

| | % of the Pensions Deficit to GDP | | | | | | | | | | |
|--|----------------------------------|------|------|------|------|------|------|------|------|------|------|
| | 2007 | 2013 | 2015 | 2020 | 2025 | 2027 | 2030 | 2035 | 2040 | 2045 | 2050 |
| Reform Model | 2.0 | 3.9 | 4.0 | 3.8 | 3.0 | 2.4 | 2.2 | 1.9 | 2.7 | 2.6 | 2.6 |
| 'No Reform' Model | 1.8 | 3.4 | 3.7 | 4.4 | 4.7 | 4.6 | 4.3 | 3.9 | 3.7 | 3.5 | 3.3 |
| Reform Model vs 'No Reform' Model | +0.2 | +0.5 | +0.3 | -0.6 | -1.7 | -2.3 | -2.1 | -2.0 | -1.0 | -0.9 | -0.7 |
| White Paper Model | 2.6 | 4.5 | 4.6 | 4.5 | 3.8 | 3.8 | 3.4 | 2.7 | 2.5 | 2.2 | 2.1 |
| Reform Model vs White Paper Model | -0.6 | -0.6 | -0.6 | -0.7 | -0.8 | -1.3 | -1.2 | -0.8 | +0.2 | +0.4 | +0.5 |

Graph 05 below compares the performance of the deficit to GDP in percentage terms under the three scenarios.



Changes to PROST Assumptions Presented in the White Paper
Appendix I

01. Macro Economic Assumptions

The Economic Impact Assessment carried out by the Economic Policy Division of the Ministry of Finance concludes that the assumptions upon which the modelling of the pension reform as presented in the White Paper is too optimistic. On the basis of this conclusion the Pensions Working Group decided to adopt more cautious assumptions for the post consultation modelling. The changes to the original assumptions are the following:

01. Nominal date for GDP is updated to reflect the press release published by the NSO dated 10th March 2005. Data for GDP is now based on the new methodology adopted by the NSO i.e. ESA 95 methodology.
02. Average Wage: the data requested in PROST for cumulative wage distribution is updated in line with the latest available information obtained from the Household Budgetary Survey (2000) (HBS). The Labour Force Survey for 2002 indicates that average wages stood at around Lm4,900. Further checks on the reliability of the values obtained for average wages from the HBS were carried out against information obtained from the Social Security Department.

The relevant input PROST table was changed as follows:

| Lm | M | F |
|-----|-----|-----|
| 2.5 | 9 | 47 |
| 3.5 | 22 | 64 |
| 4.5 | 41 | 76 |
| 5.5 | 56 | 84 |
| 7.5 | 80 | 92 |
| 9.5 | 100 | 100 |

An average wage of Lm4,850 is thus assumed for 2002.

03. Pension Brackets Cumulative Distributions: Using data generated by through the Social Security Information System (SABS) data in the relevant PROST input file is updated accordingly. No major changes are, however, recorded.
04. GDP growth is changed to reflect the following economic behaviour:

| Year | Changes in GDP |
|-------------|--|
| 2002 | 2.2% (Based on 10 th March 2005 NSO release) |
| 2003 | -1.8% (Based on 10 th March 2005 NSO release) |
| 2004 | 1.5% (Based on 10 th March 2005 NSO release) |
| | |
| 2005 | 1.7% (as at March 2005 EPD projections) |
| 2006 | 2.0% (as at March 2005 EPD projections) |
| 2007 – 2011 | 2.5% (as at March 2005 EPD projections) |
| 2012 | 3% |
| 2013 – 2015 | 3.5% |
| 2016 – 2025 | 4% |
| 2026 – 2072 | 2.5%. |

The new set of assumptions project a more modest rate of growth for GDP during the first years of the forecast. GDP growth rates rise to around 4 per cent by 2016 and level out at 2.5 per cent thereafter.

05. Productivity Growth of Minimum Wage Workers: The relevant input sheet is calibrated to approximate the wage bill to the Nominal GDP ratio, in line with latest published figures and other data obtained from various sources.
06. Inflation rate is changed as follows:

| Year | Changes in inflation |
|-------------|---|
| 2002 | 2.3% (Based on NSO release) |
| 2003 | 1.3% (Based on NSO release) |
| 2004 | 2.8% (Based on NSO release) |
| | |
| 2005 | 2.4% (as at March 2005 EPD projections) |
| 2006 | 1.9% (as at March 2005 EPD projections) |
| 2007 | 1.9% (as at March 2005 EPD projections) |
| 2008 – 2072 | 202%. |

WPM assumption was that inflation would be 2.5% throughout the modelling period.

07. Demographic Trends of Male births in proportion to Females: this changed to reflect position as at 2002 figures to stand. This now reads as 110 for males per statistics provided by NSO.
08. Labour Participation Rate: various changes were made in the input values for the Labour Force Participation rate in the base year and the forecast years. The base year values were updated to reflect the latest available activity rates for females as provided by the Labour Force Survey (NSO) i.e around 37 per cent. It is assumed that the Labour Force Participation rate for females increases to 52 per cent by 2020 and rises to 62 per cent by 2072 (as per the White Paper assumptions).

02. Pension Reform Specific Assumptions

01. Given the possibility of early retirement in the proposed reform for manual workers, it is specifically assumed for modelling purposes that 10% of the annual labour stock will opt out every year.
02. The ceiling on contributions for the second pillar is set at Lm9000 in 2007, the year of the introduction of the reform (in line with the new ceiling on Switchers). The second pillar contribution ceiling is assumed to rise to Lm15000 in 2011 and indexed with developments in wage growth and the RPI in the following proportions; 70% wage growth, 30% RPI.

Technical Team
Appendix II

| Member | Department |
|--|------------------------------------|
| Mr Damian Xuereb Ms Jacqueline Gauci | Cabinet Committees' Support Unit |
| Ms Marisa Grech | Management Efficiency Unit |
| Ms Marianne Scicluna Mr Robert Higgans | Malta Financial Services Authority |
| Mr Carl Camilleri Mr Godwin Mifsud | Economic Policy Division |
| Mr Joseph B Camilleri Mr Frankie Micallef | Department for Social Services |

Results of Some of the Simulations Modelled on PROST
Appendix III

01. Simulations Carried Out

The Pensions Working Group modelled a considerable number of simulations in order to seek a permutation for reform that balances the various policy instruments (retirement age, Two-Thirds Pension, Second Pillar Pension, etc related changes) in order to attain a reform solution that balances adequacy and sustainability. The models presented in this Appendix are limited only to some of the different scenarios applied to the best-balanced reform framework designed by the Group. In carrying out these as well as other scenarios on the best balanced reform option the Group sought to simulate assess whether a different approach to a particular policy instrument (for example a 63 year retirement age as against a 65 year retirement age) would result in an improved adequacy and sustainability balance.

02. Simulations of the Reform Proposals

Where so possible the Group simulated the proposals for reform received as a part of the consultation process. Unfortunately a small number of the proposals received could be considered as complete reform proposals with the appropriate specificity to allow for modelling. Even the most complete of proposed reform solutions required the Group to make a number of assumptions. In the main, the assumptions taken were:

- where no statement was made on a recommendation in the White Paper, the Group assumed that this was agreed to.
- where a statement for a different proposal was made to the recommendation in the White Paper but no specificity was stated, the Group adopted the recommendation it proposes in the Final Report.

It is pertinent to underline that the Group trained a number of economists at the Malta Council for Economic and Social Development in the application of PROST and invited interested parties to make use of this capacity so that proposed models for reform are generated independently from the Group.

03. General Limitations of PROST (Pension Reform Options Simulations Toolkit) – World Bank

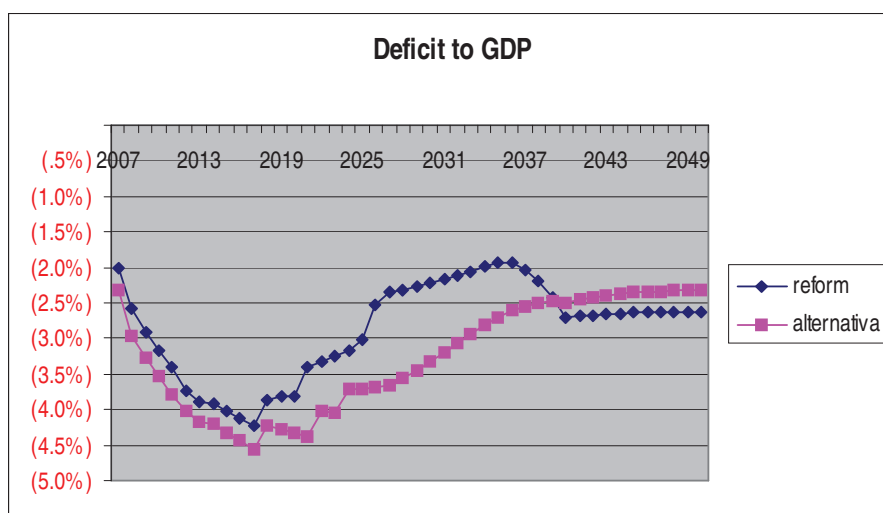
Given the modelling structure of PROST a number of limitations were encountered during the scenario exercises undertaken to assess various options for policy reform. These limitations are primarily the result of the significant level of detail that was requested in the various modelling options and the particular characteristics of the Maltese pension system. One can highlight a number of limitations:

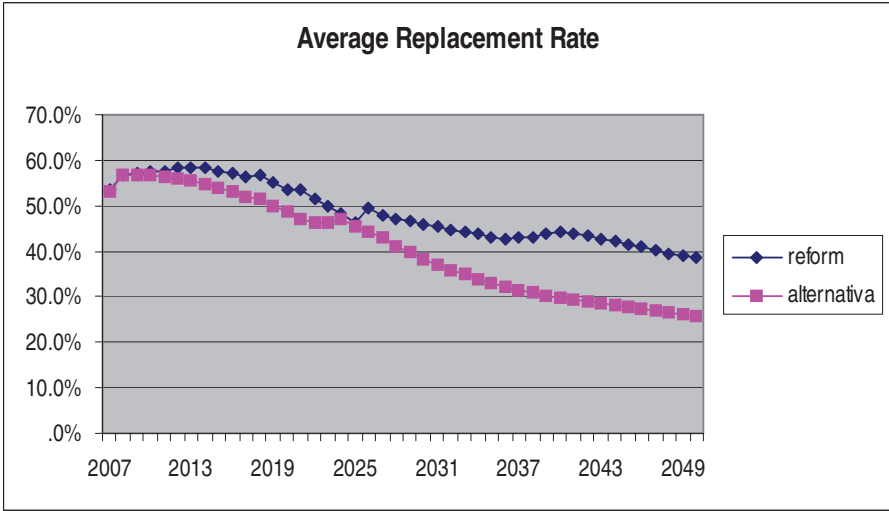
- The modelling in PROST does not allow for different ceilings (related to contributions to be paid to the system) for different persons of different age brackets. PROST distinguishes between the contribution ceilings of two specific groups, the switchers and the non-switchers.
- PROST distinguishes between the contribution rate paid by employees and that paid by employers. However, the modelling in PROST does not allow for different contribution rates related to different income level earners. A common contribution rate is used instead as a proxy of the different contribution rates for different income level earners.
- The macro-economic assumptions in PROST are exogenous to changes in any of the demographic or other assumptions taken in PROST.

Main assumptions used for modelling:

- Retirement age to rise to 65 years as in White Paper.
- Early retirement is an option. It is assumed that 10% will claim early retirement. A 6% penalty reduction for early retirement is assumed.
- Contributions from employees and employers will remain at 10%, whilst contributions from the self employed will increase to 20%. 2% of the contributions from the employed will go to a special health fund as in White paper.
- Pensions are indexed to inflation as in White Paper. The report suggests that a special inflation indexing reflecting the life-style of pensioners should be used instead. Such an index exists but one should note that this inflation elderly index is below the normal RPI index used in the White Paper. This would lead to lower increases granted to pensioners. Hence the White Paper recommendation is retained.
- The minimum pension is assumed to increase annually by the rate of inflation (as in White Paper).
- There is no ceiling on second pillar contributions and the maximum pensionable income for the First Pillar is adjusted yearly to reflect inflation (as in White Paper).
- The basis for full pension entitlement is set at 35 years. (For modelling purposes the trajectory followed to reach 35 years is as in the White Paper).
- The base line for the calculation of the Two-Thirds Pension is set at 35 years. The gradual introduction of this measure is as proposed in the White Paper.
- The second pillar scheme is mandatory as in the White Paper.

All other assumptions required for modelling purposes which are not specifically listed in the feedback presented by the Party in question have been kept as in the White Paper.

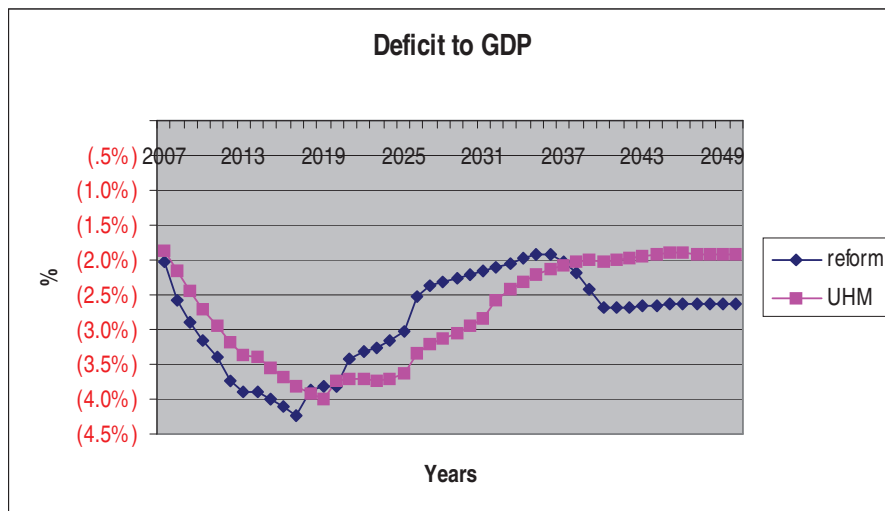


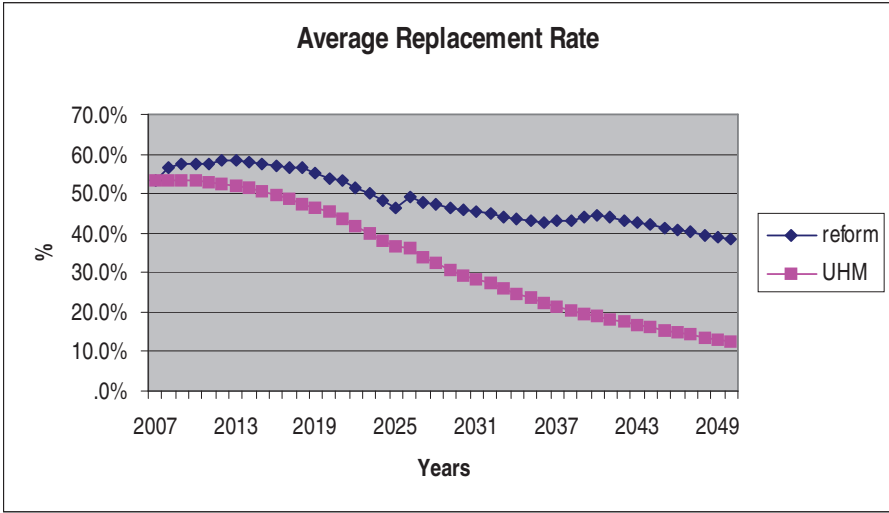


Main assumptions used for modelling:

- The retirement age reaches 65 years in line with Table 01 presented in the feedback report.
- 20% of the population is assumed to go for early retirement. (This seeks to take into account fact that the people will be given option to retire once they reach 40 years of contributions. A 6% penalty for early retirement is assumed (as in reform proposal).
- Contributions from employees and employers will be of 10% each respectively. (No carve out will be made for Health expenditure).
- Maximum pensionable income ceiling gradually increases by annual cost of living adjustment (80% of inflation approx). For modelling purposes it is assumed that ceiling on first and second pillar is the same (given that no information is given on ceiling for second pillar in feedback document)
- Pensions should be indexed to wages.
- No specific reference is made to the indexation method for minimum pension. The White Paper assumption thus holds.
- The contribution period for the accumulation of the Two-Thirds Pension is as in White paper.
- The base line for the calculation of the Two-Thirds Pension is set as the best three years out of the last 10 years.
- Switchers are assumed to be those who are 40 years old on the date of the start of the reform.
- 2nd pillar is not obligatory. For modelling purposes given that no specific assumptions are given out in the feedback document, it is assumed that take up rates are as in White Paper and that take up rates of 10% are assumed after 2010 throughout the full forecast horizon.
- The proposition that any person who would have paid 40 years of National Insurance Contributions before reaching retirement age would be able to retire is not modelled in this simulation.

All other assumptions required for modelling purposes which are not specifically listed in the feedback presented by the Party in question have been kept as in the White Paper.

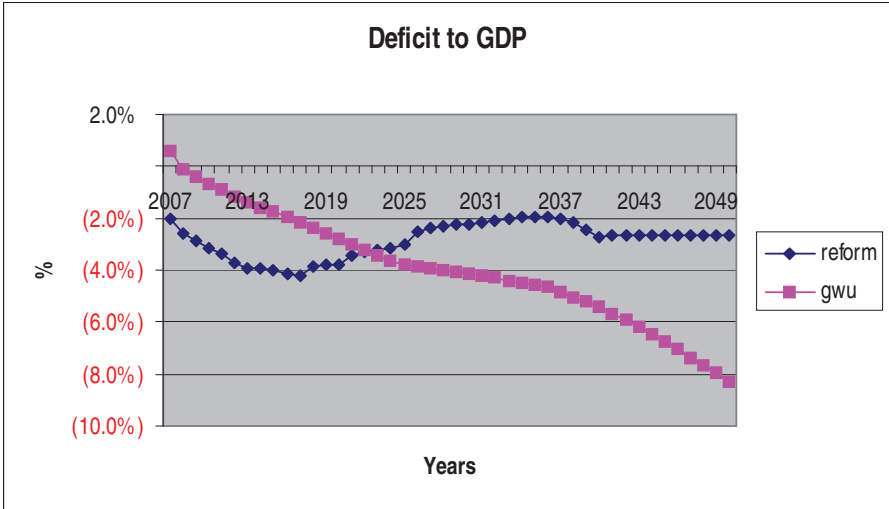


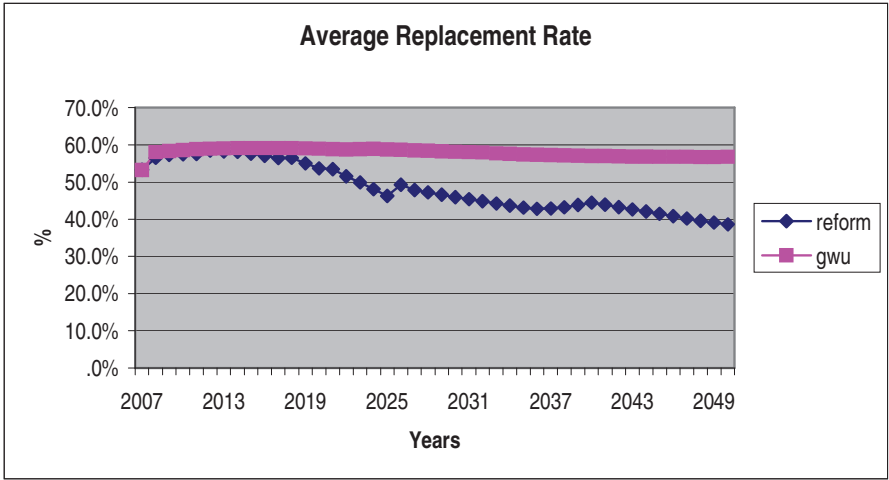


Main assumptions used for modelling:

- It is assumed that the retirement age is kept at 61 for males and at 60 for females throughout the forecast horizon. The decision to work in excess of the official retirement age is purely voluntary and not specifically modelled.
- Given the modelling limitations of PROST, a contribution rate of 11.9 per cent was used both for employers and employees. This rate is a weighted average obtained using the proposed rates in line with the earning profile as suggested in the report and an income distribution breakdown as provided to the Technical team by the National Statistics Office (in line with the latest Household Budgetary Survey).
- The 2nd Pillar is introduced on a voluntary basis.
- Maximum and Minimum pension levels are fully indexed to wage growth.
- Pensions are indexed to wage growth.
- All ceilings are removed.
- For modelling purposes the Maximum pension is set at a high level of around Lm16,000 in 2007, the starting year of the reform.
- The contribution period for the accumulation of the Two-Thirds Pension increased to 35 years as from 2007.
- The base line for the calculation of the Two-Thirds Pension will be the best three years out of the last ten years.

All other assumptions required for modelling purposes which are not specifically listed in the feedback presented by the organisation in question have been kept as in the White Paper.



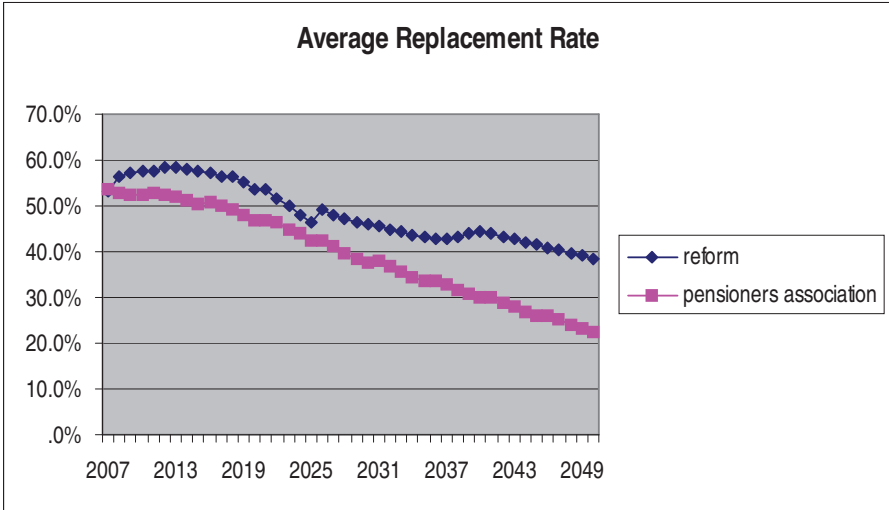
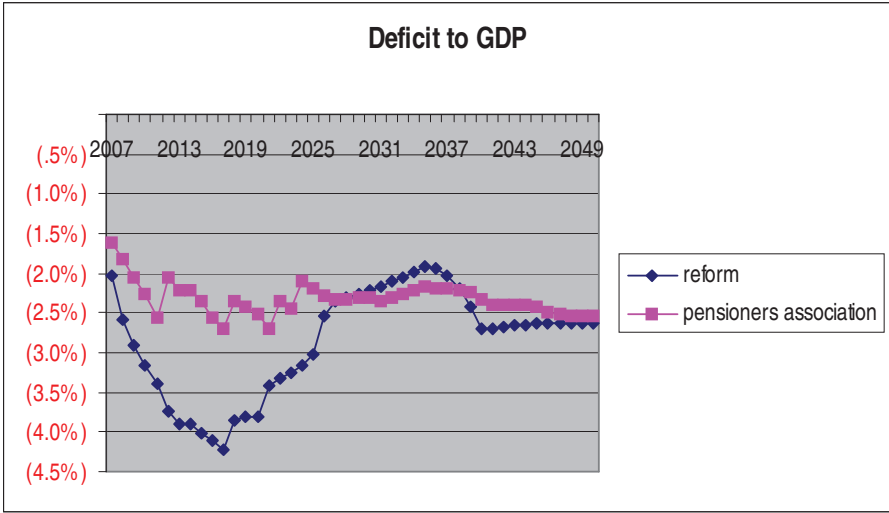


National Association of Pensioners

Main assumptions:

- The feedback report proposes that pensions should be indexed to inflation and be supplemented by a percentage increase at 5 yearly intervals equal to the percentage increase of the average of Scales 1 to 20 in the public service. For modelling purposes pensions are fully indexed to inflation and supplemented at 5 yearly intervals by the average increase in wage growth for the last 5 years in question.
- The minimum pension guarantee is assumed to increase annually by the rate of inflation based on the Retail Price Index.
- The maximum pensionable income is raised immediately to Lm8000 and increased every year by the rate of inflation and every five years by an additional percentage to reflect average 5 year wage growth.
- Given that the modelling exercise excludes the contribution by the State to the Pension system (based on World Bank guidelines) then the proposition that the contribution of the State should go down to 25% is not modelled in this scenario.
- Retirement age to increase to 65 years, with possibility of early retirement. For modelling purposes a 6% penalty for early retirement is assumed (as in reform proposal).
- The Association proposed a new trajectory for the implementation of the 40-yr Contribution period. Persons above 45 years of age are not affected by the changes whilst those below 30 years of age at the date of the reform will have their contribution period based on 40 years.
- The baseline for the calculation of pensions is modelled as proposed by the Association. Persons below the age of 40 years at the date of the introduction of the reform will have their pension based on the best 120 consecutive months (10 yrs), whilst those above 40 years but below 50, will have their pension based on the best 60 consecutive months (5 years).
- For modelling purposes switchers are assumed to include all those below the age of 40 years in the year of the implementation of the reform.
- The 2nd pillar pension is to be voluntary in nature. For modelling purposes no contribution ceiling is set for voluntary second pillar contributions.
- Increases in contribution rates for all employees, employers and the self employed in line with economic pick up. For modelling purposes this is implemented from 2012 onwards.
- No contribution funds are channelled to the Health Fund.

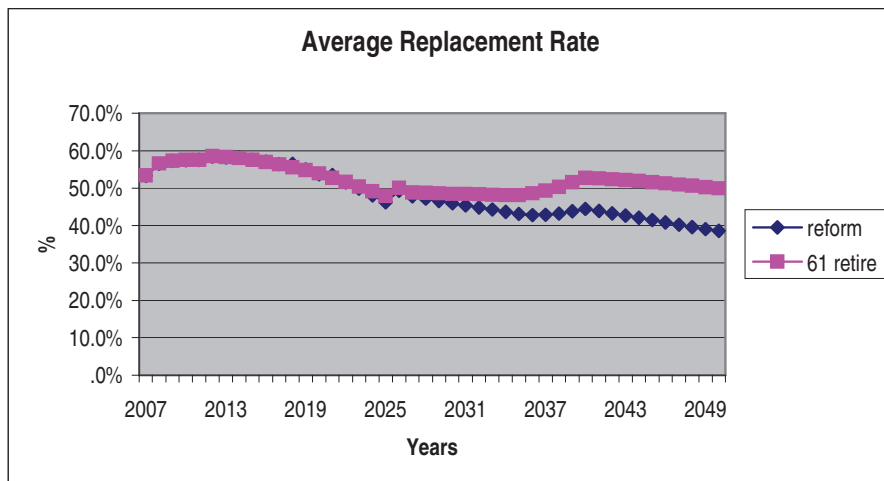
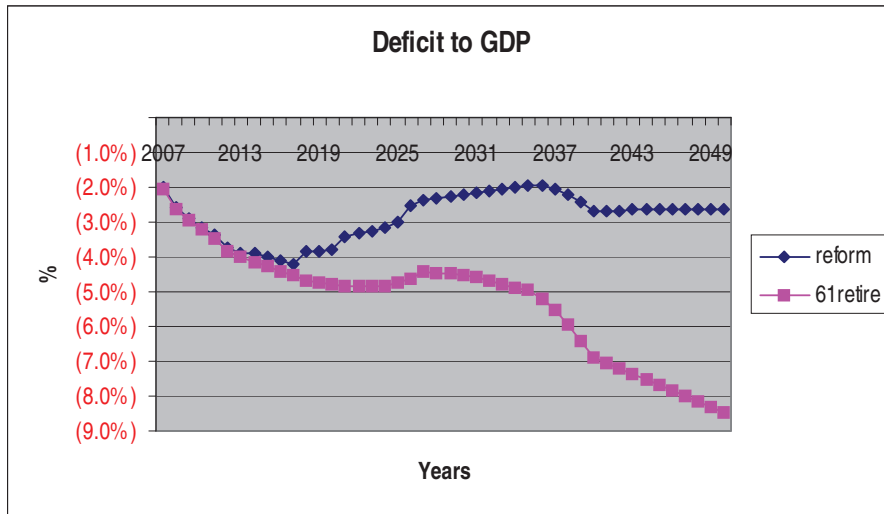
All other assumptions required for modelling purposes which are not specifically listed in the feedback presented by the Association in question have been kept as in the White Paper.



Scenario 1: Reform proposal but with retirement age set at 61 years both for males and females

Other main assumptions:

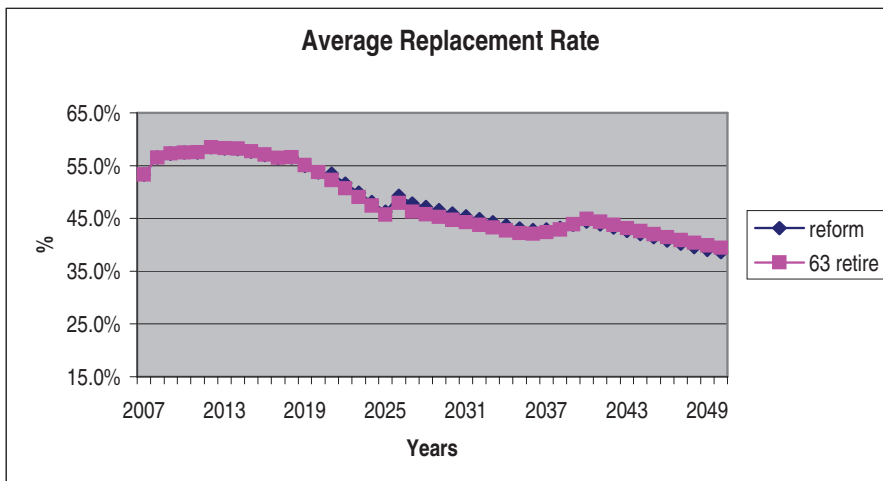
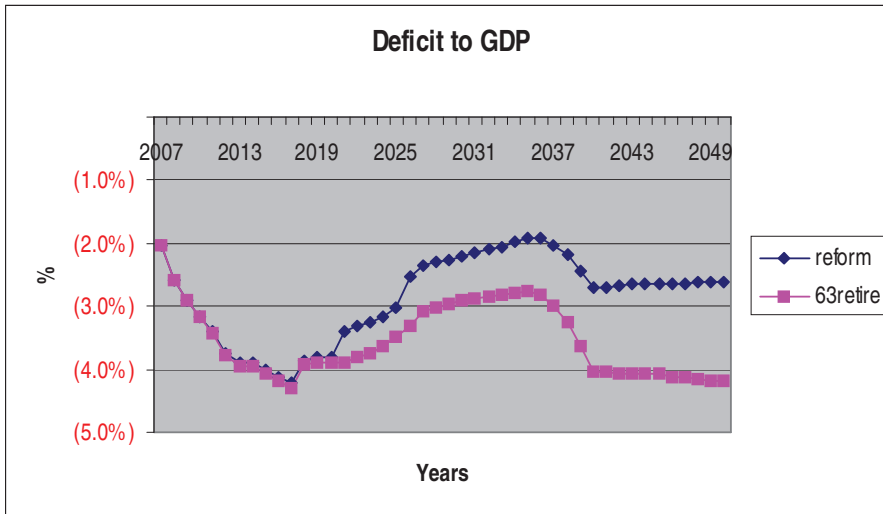
- 30 years contribution period for the accumulation of the full Two-Thirds Pension.
- There is no possibility of early retirement.
- Other required assumptions for modelling purposes as in reform proposal.



Scenario 2: Reform proposal but with retirement age set at 63 years both for males and females

Other main assumptions:

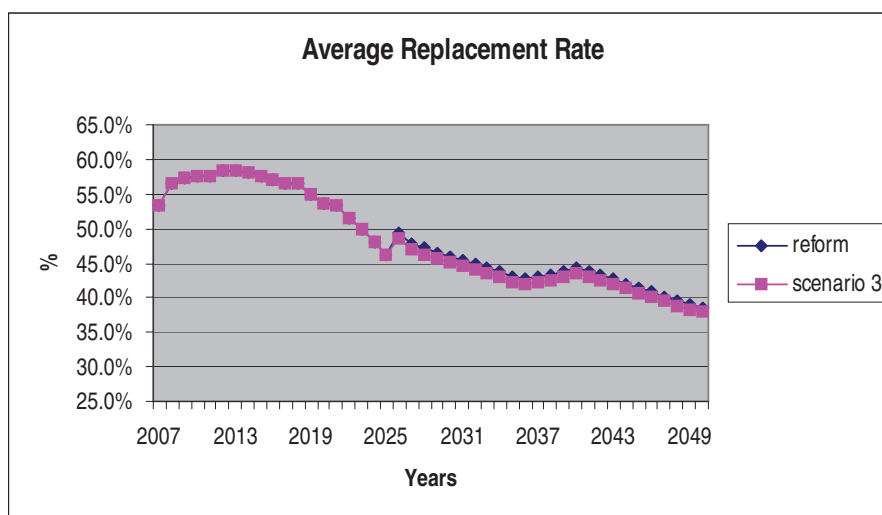
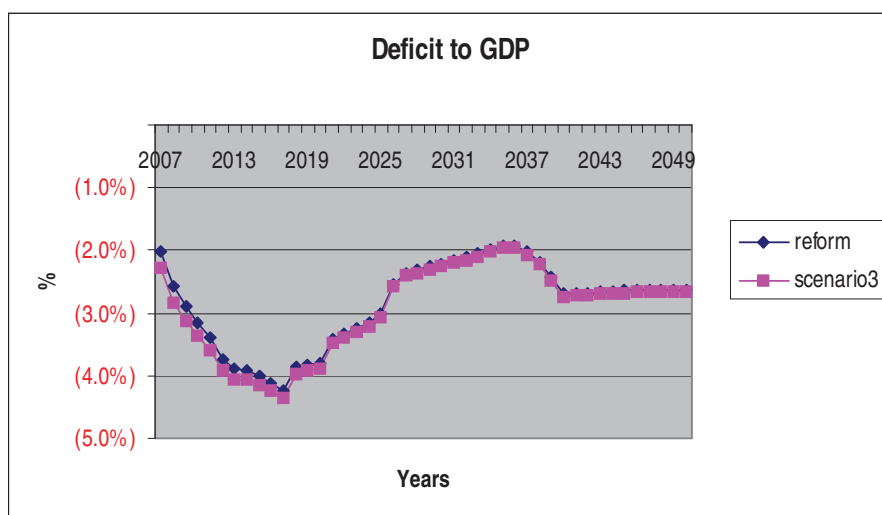
- The trajectory for the increase in retirement age to 63 years follows the reform proposal.
- 35 years contribution period for the accumulation of the full Two-Thirds Pension required.
- Possibility of early retirement – 10% claim early retirement with penalty of 6% - maximum early retirement of 2 years.
- Other required assumptions for modelling purposes as in reform proposal.



Scenario 3: Reform proposal but with 2% of contributions from the employee being carved out to a Health Fund

Main assumption:

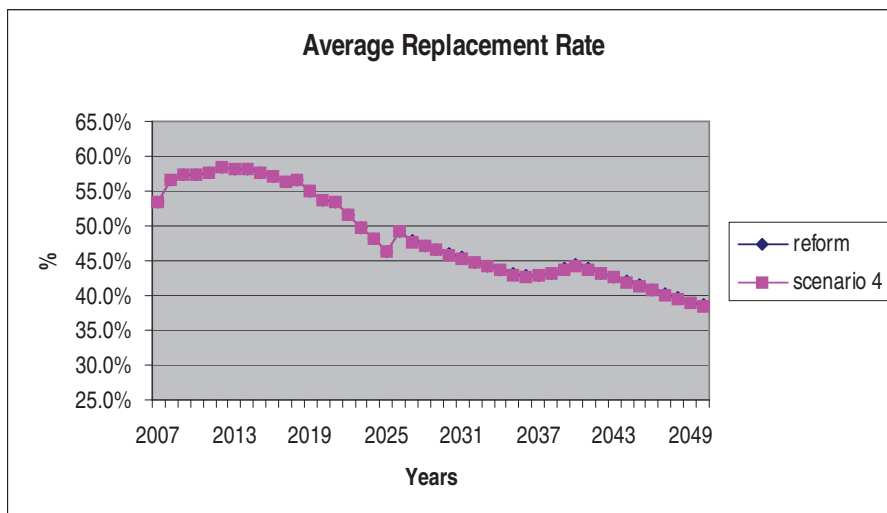
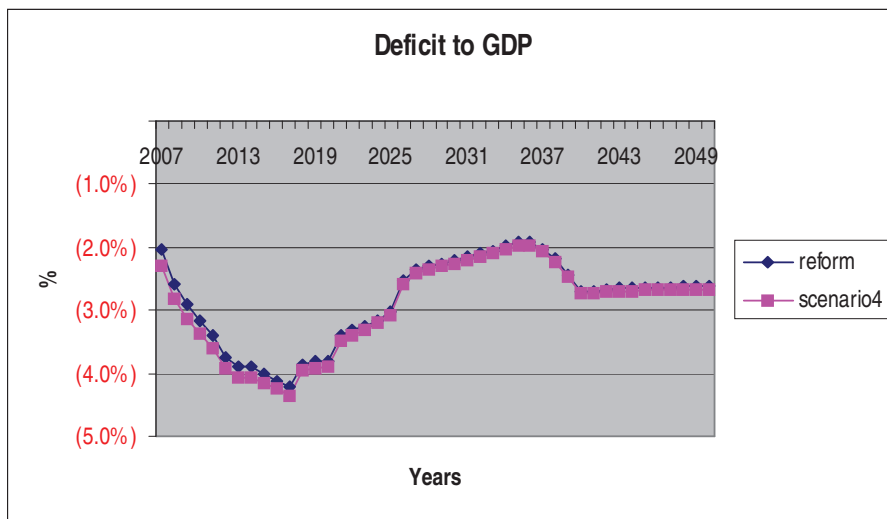
- 2% of social security contribution by employees is carved out of the 10% contribution towards a special Health fund.
- Other required assumptions for modelling purposes as in reform proposal.



Scenario 4: Reform proposal but with 2% of contributions from the employee being carved out to a Health Fund and additional increase in contributions to the second pillar

Main assumptions:

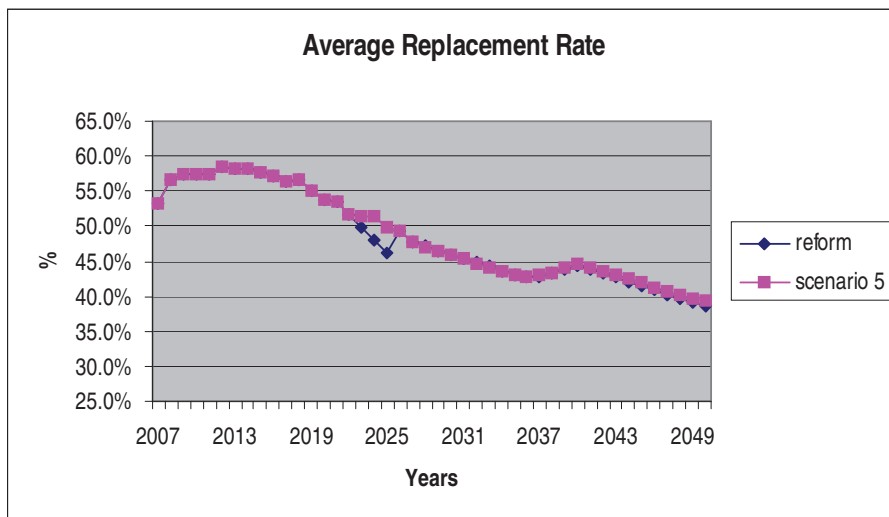
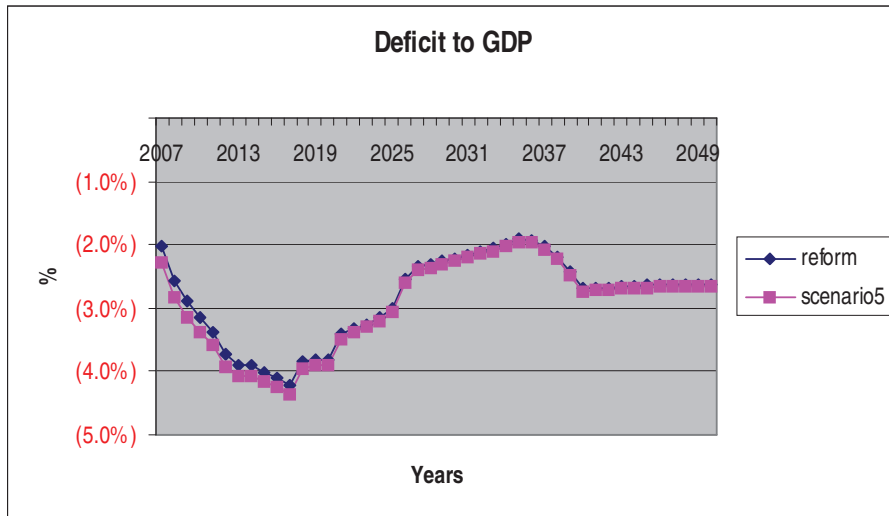
- 2% of social security contribution by employees is carved out of the 10% contribution towards a special Health fund.
- Employer and Employee contributions to the second pillar are increased by a further percentage point in year 2011. Thus whereas 1% per cent is assumed collected in the reform proposal from the employee and the employer in 2011, this scenario assumed a collection rate of 2% respectively from each side.



Scenario 5: Reform proposal but with 2% of contributions from the employee being carved out to a Health Fund and additional increase in contributions to the second pillar for 2030

Main assumptions:

- 2% of social security contribution by employees is carved out of the 10% contribution towards a special Health fund.
- The contribution rate for the second pillar from employees and employers increased by a further percentage point in 2030, to reach the rate as in the White Paper, i.e. 5 per cent.

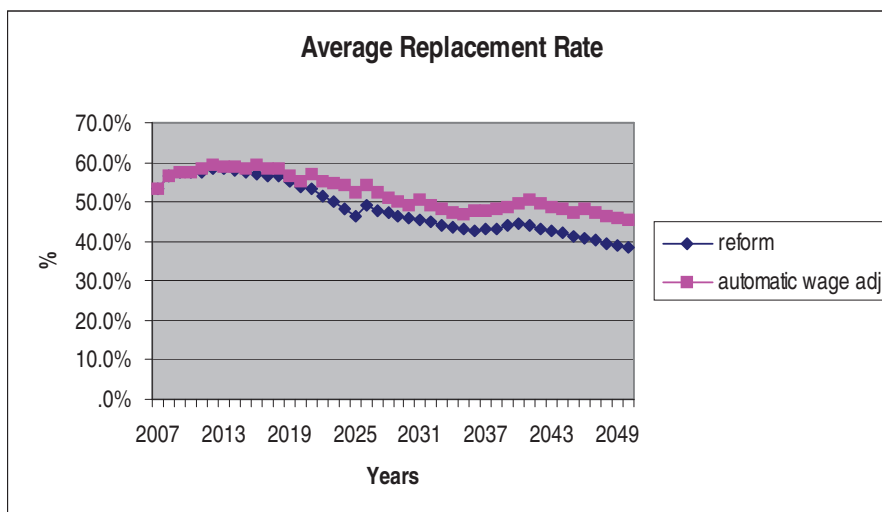
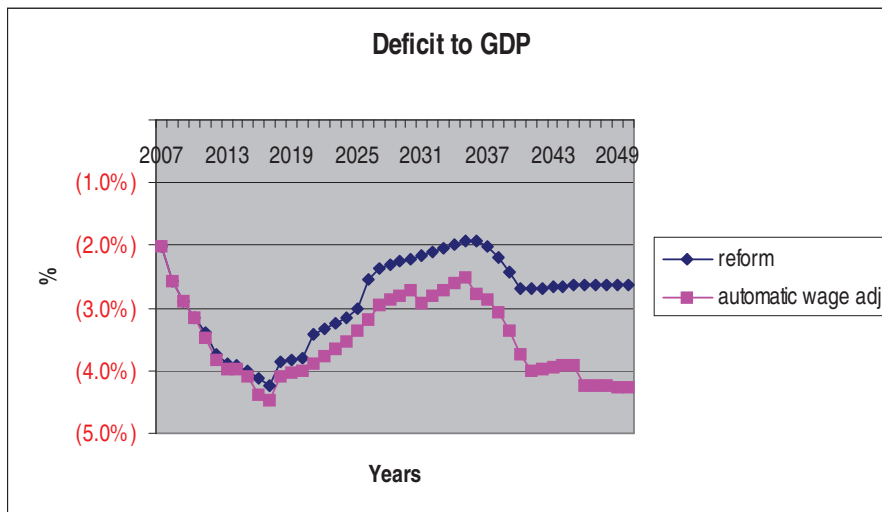


Scenario 6: Reform proposal with additional five yearly automatic adjustment equal to the average growth in wages for a five year period

Main assumptions:

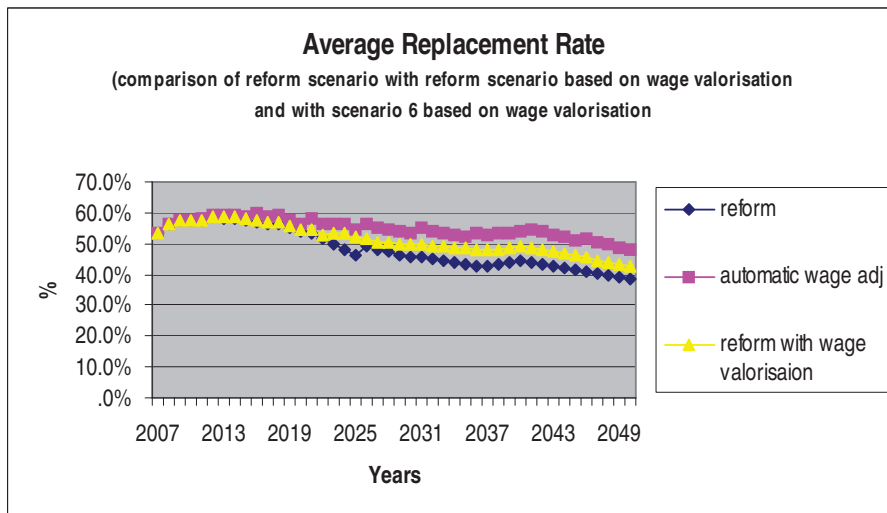
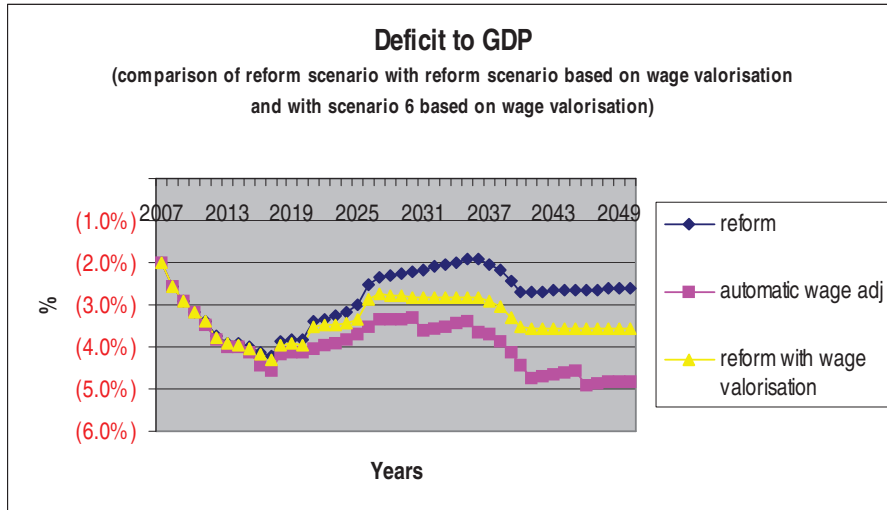
- Maximum pension and Minimum pensions topped up every five years with the average increase in wages for the last five-year period.
- Pensions indexation as in reform scenario but with additional five yearly top-up equivalent to the average growth in wages for a five-year period.
- Other required assumptions for modelling purposes as in reform proposal.

The automatic adjustment given every five years is calculated using the average real growth in wages over the last five year period.



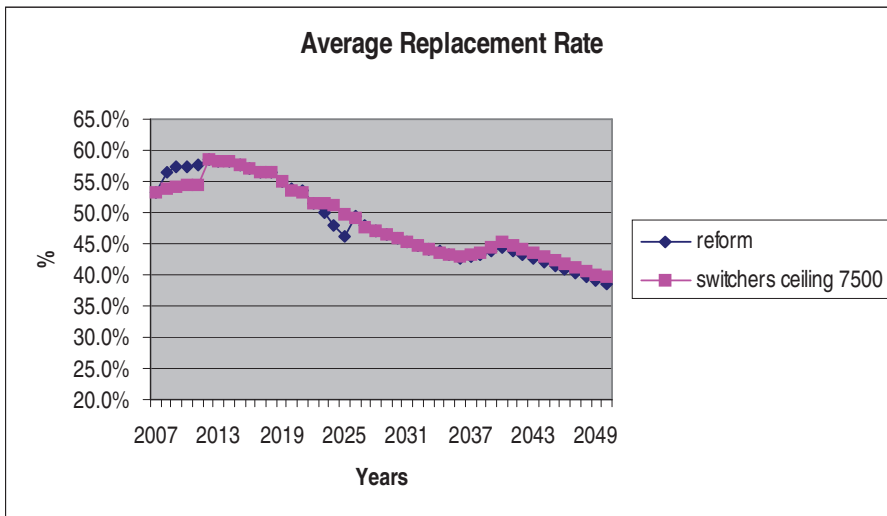
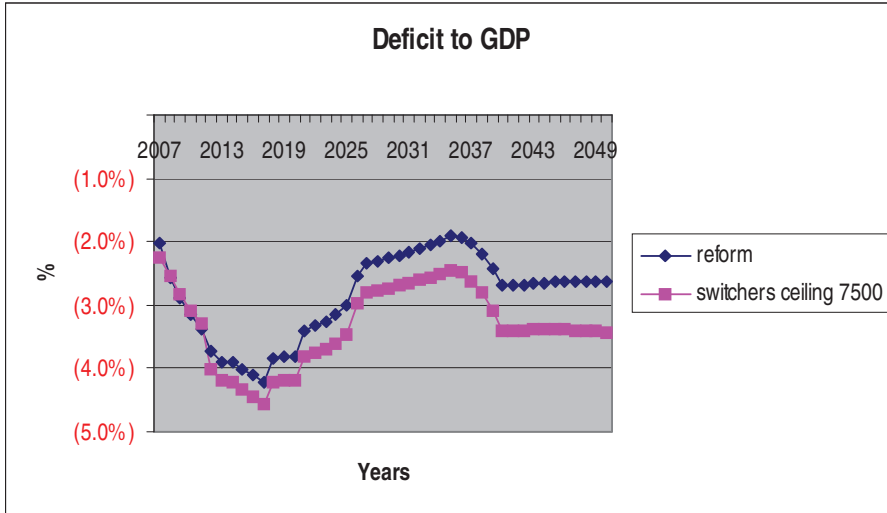
**Scenario 7 and 8: The Reform Proposal with wage valorisation of pensions,
and scenario 6 applied with wage valorisation of pensions**

- The following charts illustrate the Deficit to GDP ratio and the Average Replacement rates if wages are used to valorise pensions as compared to the use of the RPI. The two charts compare the trajectory under the reform scenario using wage valorisation and scenario 6 above under the assumption of wage valorisation to the reform proposal.



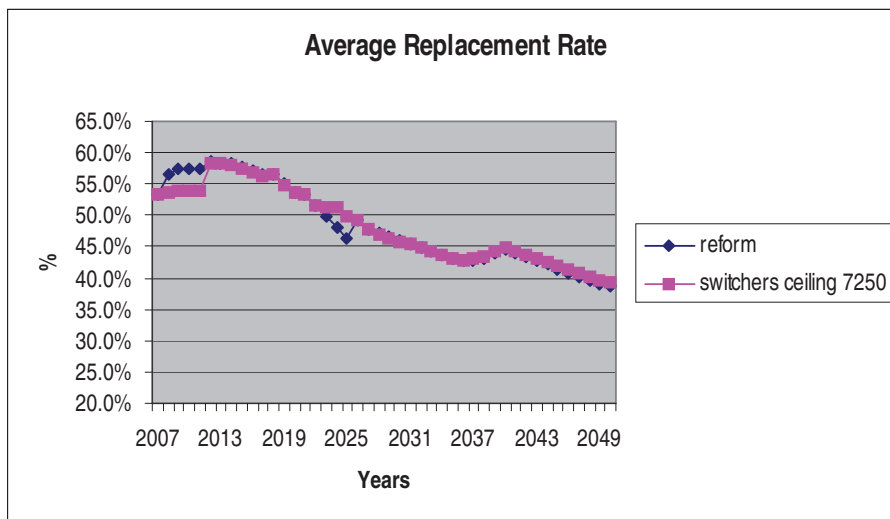
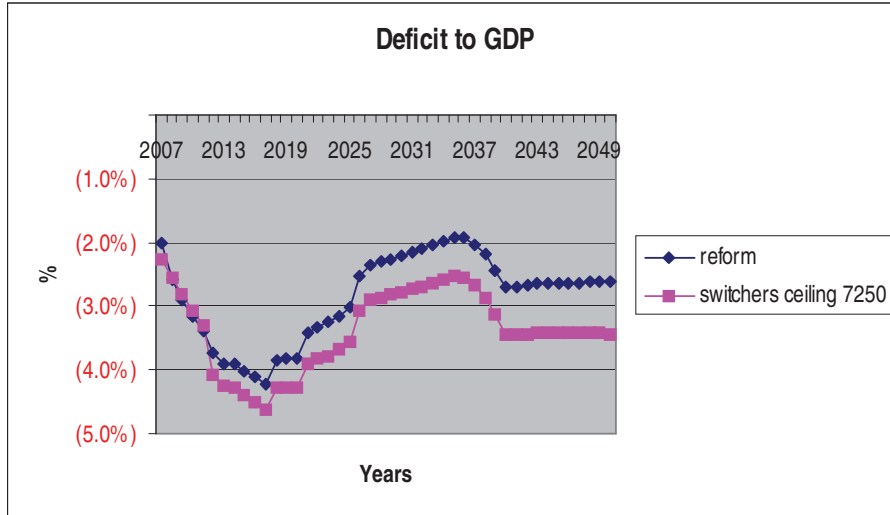
Scenario 9: Reform scenario but the ceiling on switchers in 2007 is fixed at Lm7500

- Other required assumptions for modelling purposes as in reform proposal.



Scenario 10: Reform scenario but the ceiling on switchers in 2007 is fixed at Lm7250

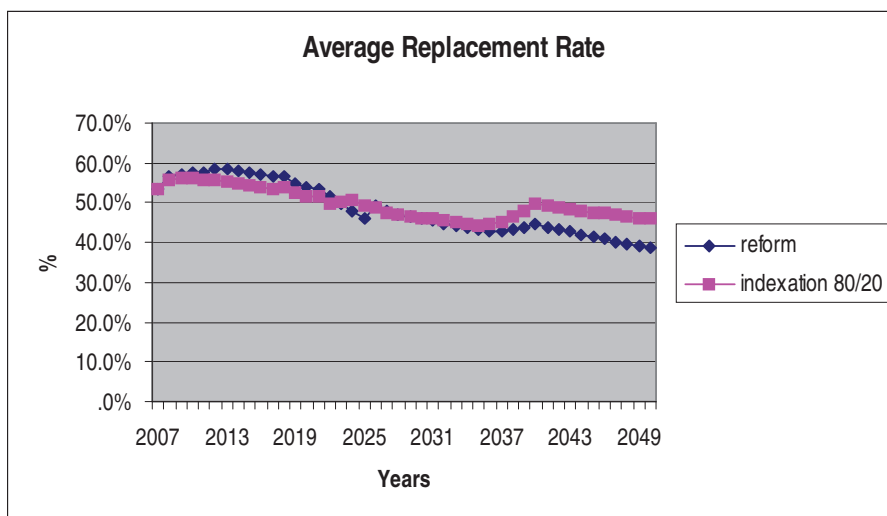
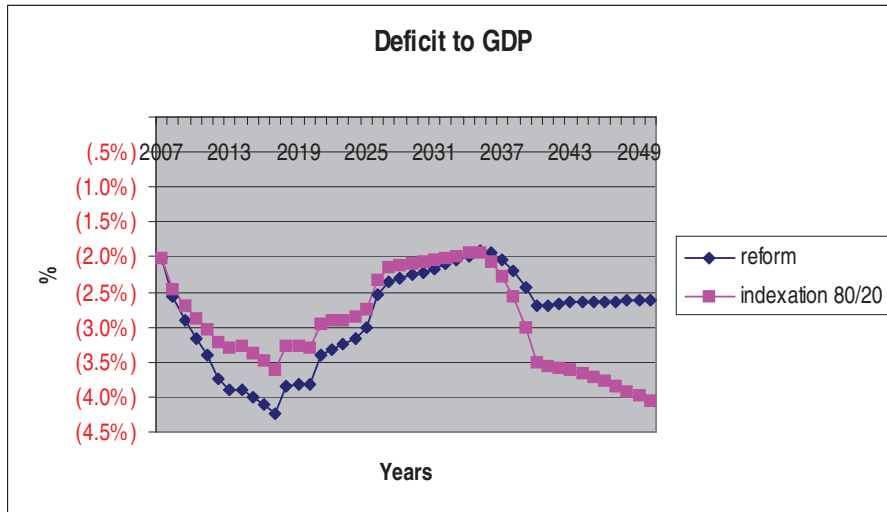
- Other required assumptions for modelling purposes as in reform proposal.



Scenario 11: Reform proposal with different assumptions on pension and contribution indexation. The growth in the contribution ceiling, maximum pension, minimum pension and pension indexation, follows 80 per cent of changes in wages and 20 per cent of changes in inflation

Main assumptions:

- Maximum pension, minimum pension and pension indexation grow by 80 per cent of changes in wages and 20 per cent of changes in inflation.
- Pensions indexation linked to 80 per cent of changes in wages and 20 per cent of changes in inflation.
- Other required assumptions for modelling purposes as in reform proposal.



Scenario 12: Reform proposal with different assumptions on pension and contribution indexation. The growth in the contribution ceiling, maximum pension, minimum pension and pension indexation, follows 50 per cent of changes in wages and 50 per cent of changes in inflation

Main assumptions:

- Maximum pension, minimum pension and pension indexation grow by 50 per cent of changes in wages and 50 per cent of changes in inflation.
- Pensions indexation linked to 50 per cent of changes in wages and 50 per cent of changes in inflation.
- Other required assumptions for modelling purposes as in reform proposal.

