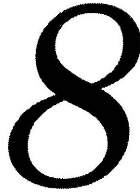

Malta Retirement Funds

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The Malta Financial Services Centre gave details earlier this year of draft legislation which if approved by Government could be an important building block in the development of private pensions in Malta. The Malta Retirement Funds Bill, as it is appropriately called, attracted much interest amongst practitioners in the financial services industry. But apart from this, there has been very little media commentary of what the proposed legislation has to offer.

The proposed Act goes beyond the provision of retirement schemes for domestic purposes. Indeed when it was first drawn up, the Draft Law was called the Malta International Retirement Funds Act. The idea has been that of creating the legal framework to attract international companies offering retirement benefit packages and schemes to expatriates and companies employing them.

International Needs

Schemes offered in high-tax countries may give some tax benefits, but suffer from the lack of flexibility inherent in national pension legislation. With more and more individuals and companies basing themselves internationally, there is a growing market place for cross-frontier pension provision, and this is the market, which the MFSC had in mind when it originally launched this project.

Individuals, like expatriate executives, professionals or entertainers, in a number of situations, can benefit from cross-border pension investment.

Consider some of the dilemmas these or similar types of global wanderers have to face when planning their own pension provision.

Firstly, their contributions to eligible national plans are often tax-exempt but only if they are resident in that country. As these global wanderers locate to non-resident status, they lose this tax privilege.

Secondly, their contributions to eligible national plans are often tax-exempt up to a maximum limit. As their earnings exceed this amount they are liable to pay tax.

Thirdly, offshore investment is often the only practicable route, because it preserves the flexibility of not committing oneself to any particular high-tax jurisdiction at time of retirement. Assuming that the income they are going to receive in retirement is not going to be taxed at source, it gives them the flexibility to decide, where to locate their retirement when they stop working.

A number of countries have already poised themselves to capitalize on the potential of this growing market for international retirement business. Among these are Luxembourg with its Law on Pension Funds of June 1999, and the Isle of Man with its Retirement Benefits Schemes Act which came into force in June 2000. Competitive alternatives for the provision of supplementary pensions to expatriates can also be found in Jersey and Bermuda.

A Regime which also Caters for Local Requirements

The Bill also caters for local requirements. No matter whether one is a global wanderer or a sedentary islander, one would be extremely careful about the security of his chosen retirement product, and he will no doubt plan to maximize his income in retirement.

This is why the proposed law, because of its general and comprehensive approach, lends itself well to domestic use, and this is welcome to many of us, and to the international organizations, which guard against domestic ring fencing.

This is achieved because the Draft Law applies equally to international and domestic use. It provides the legal framework for the regulation and supervision by MFSC of private retirement schemes, and does so without discriminating between local or overseas schemes.

But in so doing it does not pre-empt any of the tasks assigned to the National Commission for Welfare Reform established in 1999. That Commission had been asked to examine the social security system in Malta and its sustainability, and to make recommendations on possible reform. Its focus was the basic State Pension and it is therefore an inquiry into the First Tier or State Pension provision in our Islands.

Governments in other countries have gone the route of statutory provision of occupational pension plans by employers, or the alternative route of voluntary provision, while trying to limit exclusions from these plans as much as possible.

The draft legislation is not concerned with these developments, because this has not been its remit. The Bill is rather

intended to encourage Maltese and international employers to develop retirement benefit schemes in Malta, creating additional employment opportunities and complementing other financial services initiatives in Malta.

Background to the New Law

To varying degrees, most retired persons rely on some combination of the three pillars of retirement income: (i) government programmes, (ii) employer pension schemes, and (iii) private savings.

The Bill is intended to develop and encourage funded second and, to some extent, third pillar retirement benefit arrangements. Second pillar retirement benefit arrangements are those schemes which are arranged between an employer and his employees. Third pillar arrangements involve a contributor who invests in a retirement scheme for his own benefit (for example, a top-up arrangement).

Overview of the Bill

The Bill defines and provides a regulatory scheme for:

- The arrangement pursuant to which an employer or contributor promises the employee or beneficiary retirement benefits (called a scheme). The law would require such an arrangement or scheme to be registered. Registered schemes could also be used by employees to top up their existing pensions, or by the self-employed;
- The types of funds (called Retirement Funds) that are required to be used as investment vehicles by a registered scheme; and
- The types of service providers that may provide services in connection with a registered scheme or Retirement Fund (the principal ones being Registered Administrators and Registered Asset Managers).

The Bill makes provisions for the regulation of retirement schemes. The legislation is intended to cover schemes which provide benefits to residents of Malta as well as to non-residents. It is divided into three parts:

Part I contains the basic definitions: Retirement benefits are defined as a pension or other benefits that are payable to a beneficiary after retirement, permanent invalidity or death. A retirement scheme is one which stipulates that no benefit can be paid before the beneficiary attains the age of 50 or after 70, except in those cases where a payment is in respect of a permanent invalidity.

Part II contains the essential requirements for Retirement Funds and registered schemes. The legislation requires that the benefits provided in such schemes would be funded through the use of one or more Retirement Funds, and that the administrator and asset managers of such Funds will also be registered and regulated by the MFSC. The MFSC also has a role in monitoring the ongoing compliance of registered schemes and Retirement Funds with the Bill's requirements. This part of the Bill also contains various powers to prescribe detailed requirements, including provisions relating to the advertising and promotion of schemes and Retirement Funds, the spread of investments to be included in a Fund, and the extent to which investments and loans may be made by or to contributors.

Part III of the Bill contains general provisions describing the powers of the Minister and the MFSC, and the various penalties for non-compliance.

Retirement Scheme Structures

At the outset, an employer who wishes to provide a retirement scheme to his employees or a certain segment of them, will have to establish a Retirement Scheme. This is a contract under which the employer agrees to pay contributions for the purpose of building a fund from which retirement benefits would be available to the employees. This contract or scheme also involves nominating a person as Administrator for the operation of the Scheme on a day-to-day basis.

Types of Retirement Schemes

A Scheme may be either a defined benefit scheme, or a defined contribution scheme.

A defined benefit scheme is primarily intended for the provision of fixed or determinable benefits. Defined benefit schemes are normally based on a combination of years of service in a retirement scheme and the level of earnings attained at or near retirement. In such a funded scheme, contributions by the employer, employee or both, will be set at levels deemed necessary to fund the defined level of benefit and to cover expenses.

On the other hand, defined contribution schemes are determined by returns or gains that are received on the invested contributions. Contribution levels may be set initially so as to achieve a desired pension after allowing for the expected investment return and for charges. Contributions may be defined in relation to a percentage of salary, or a fixed amount per month or a single payment payable from time to time. The accumulated sum is used at retirement to provide the retirement benefit to the contributor or his dependants.

Retirement Funds

A principal purpose of a Scheme is to provide benefits to the beneficiaries of the Scheme at the moment of their retirement. The law must therefore ensure that the contributions that are paid to it are kept separate from the funds of the employer. This is achieved by requiring that these be invested in one or more Retirement Funds.

A Retirement Fund is a separate company, and is therefore set apart from the employer's assets. This is important because the segregation of assets ensures that the retirement rights of employees are protected in the event of the employer's insolvency, even in the case of insufficient funding, provided that the Retirement Fund has sufficient ranking amongst the employer's creditors. The proposed Law further provides that the creditors of an employer may not enforce their rights over the employer's interest in the Scheme; nor may such creditors attach or subject such interest to any precautionary or executive warrant. Moreover any agreement that is made whereby the employer transfers or charges his interest in the Scheme is void.

A Retirement Fund is required to be established as an investment company with fixed or variable share capital under the Companies Act 1995, for the principal purpose of holding and investing the contributions made by one or more Schemes or Overseas Retirement Plans.

A retirement fund may in turn invest its assets in all forms of financial instruments or immovable property. Directives may naturally impose prudential requirements as to the proportion of resources that may be placed in any one investment or the diversification of the scheme's assets. Moreover the new law restricts the investment of the Fund's resources in contributor-related assets. This prevents the plough-back of money to the employer or his affiliates.

Registration Requirements

The Fund, any Malta-based scheme, the Administrator and the Asset Manager can all be individually registered with the MFSC. Where a Scheme is set up from scratch, it is anticipated that a single composite registration process will in practice be operated. However, the structure is a flexible one and may be used in other situations.

For instance, where an Overseas Retirement Plan sets up a Retirement Fund, only the Fund, its Administrator and any Asset Manager will need to be registered. Where a new Administrator is appointed to a Scheme, only the new Administrator needs registration. Moreover if a Retirement Fund chooses to manage its own investments, it will not need to appoint and register an Asset Manager.

Investment Services Act Requirements

A Malta-based Asset Manager will also normally need to be licensed under the Investment Services Act 1994. An Asset Manager based outside Malta will not need an ISA license, where the MFSC is satisfied that the Asset Manager is subject to an adequate level of regulatory supervision in its country of establishment.

Currently, an Administrator who acts as a custodian or as an administrator in relation to investments or a collective investment scheme is also required to be licensed under the ISA. The ISA is, however, being amended to remove pure administration services from the list of licensable activities, and to substitute a requirement for the recognition of such administrators by the ISA.

Any other service provider carrying on ISA-licensable activities will also need to obtain an appropriate license.

Third Pillar Retirement Schemes

You will have noticed that for the sake of simplicity, we have used the term employer interchangeably with contributor, and understood the employee to be at the same time the beneficiary. This is what will normally happen.

However, a Retirement Plan may have as its contributors both employer and employees. Furthermore, it may be tailored for use outside an employment relationship. When this happens, the distinction between contributor and beneficiary fades away, as they both become one and the same person. Similarly the thin line between Occupational Pension Plans and Personal Pension arrangements also fades. The draft legislation will therefore regulate all these retirement vehicles, but not pure collective investment schemes or life insurance, because in each of these latter cases the principal purpose is not that of providing retirement benefits. Moreover, a scheme which provides for the payment of retirement benefits to five or fewer beneficiaries is excluded from regulation under the proposed legislation.

This would mean that existing collective investment schemes which are principally intended for the provision of retirement benefits, within the meaning of the law, will pass through transitional arrangements until they are converted into appropriate Retirement Schemes.

It also means that the regulatory and supervisory framework that has been assumed for Retirement Schemes under the proposed law, has a common point of departure with Collective Investment Schemes as presently regulated under the Investment Services Act. The aim here has been to provide consistency and harmonize the regulatory and supervisory approach of this new law with other financial legislation, particularly the ISA. There could, of course, be an unfortunate trade-off in all this because in the international market for retirement products, competition will require lean and swift regulatory and approval systems, somehow different from the stricter domestic standards.

Regulatory Requirements

As we have seen, defined benefit schemes promise the beneficiary a predefined level of retirement benefits, conditional on that individual's years of service and some measure of earnings. Contributions by the employer (and usually the beneficiary) are based on actuarial estimates, which means that

usually the employer's contribution can vary from year to year according to the performance of the Fund.

On the other hand, in defined contribution schemes, contributors pay a certain level of contributions, with no explicit commitment for a certain level of pension benefits at retirement. The pension paid at retirement will depend on the level of contributions, the rate of return accrued on the fund and the costs involved in converting the final fund into an annuity.

In both cases, the employer is the guarantor of the pension scheme he has set up. However, in defined contribution plans, the employer's obligation goes no further than his contribution, whilst in defined benefit plans, the obligation is tied to the promised benefit, and must guarantee sufficiency of funds at the moment of retirement.

Reliance on private retirement schemes calls for an adequate regulatory framework. This is a precondition for maintaining the confidence of beneficiaries, both at international and domestic level. Indeed, where retirement benefits are concerned, the non-payment of present or future benefits can seriously affect the lives of would-be beneficiaries and harm the image of Malta on an international level.

The Draft Law therefore requires that Retirement Benefit Schemes should be registered with the MFSC, and registration will cover both the Fund itself, the proposed Retirement Scheme, its Administrator and Asset Manager. Moreover, if the Scheme is to qualify for special tax treatment, it will have to comply with requirements laid out by the CIR. The new law also introduces innovative concepts by placing a duty on Fund Directors, Administrators, Auditors and Actuaries to blow the whistle wherever they have a reasonable cause to believe there is a compliance failure.

Another decisive supervisory tool lies within the post of the Retirement Scheme Administrator and the Retirement Fund Administrator.

The Draft Law provides that both the Retirement Scheme and Fund have to be managed externally by a Registered Administrator. This would generally be a company holding an investment services license of the appropriate category.

A scheme administrator has a number of duties. These would typically include:

- Investing all contributions in retirement funds according to the terms of the Scheme document,
- Ensuring that the scheme collects all payments that are owed to it by its contributors,
- ensuring that all disbursements are effected in accordance with the Scheme document; and
- maintaining accurate records.

On the other hand, the Retirement Fund Administrator manages the Fund and is responsible for ensuring compliance with all statutory and contractual obligations; it is his duty to arrange for the necessary financial control of the Fund, and he must provide for the audit and actuarial examination of the Fund. It is the Fund Administrator who carries the overall day-to-day responsibility for the Fund, and it is for this reason that substantial civil and criminal penalties are imposed on him in the event of a breach of duty.

The primary goal of the proposed Law is to protect beneficiaries from the effect of the Scheme's insolvency. The issue of adequate funding of plans is particularly acute in defined benefit schemes. By contrast, defined contribution schemes are in theory always technically funded, although in practice they may not be so, especially where there is misappropriation, misuse, or improper estimates of funds. Restrictions on investments in the employer's own business also provide important safeguards.

Adequate Funding

The purpose of subsidiary regulation under various provisions of the Law are to require a prudent approach to the funding of schemes; proper technical and investment decisions, and to reduce the possibility of improper funding.

At the same time, we are well aware that a healthy Fund can sometimes find itself under funded without its viability being affected. The situation may arise in the case of a sudden and significant fall in the value of assets.

In such a situation, the proposed law adopts a more stringent approach wherever a defined benefit scheme is the object of an employment relationship. The proposed law here requires that such occupational defined benefit schemes should be subject to a technical funding requirement. Simply stated, it is a duty of the Scheme Administrator and Actuary to ensure that the value of the Scheme's investments in Funds, after deduction of all liabilities, is not substantially less than the value of its future retirement payments towards its beneficiaries. This is a rule which permeates throughout the regulation of private retirement schemes and stands out as a major distinguishing feature from the present Pay-as-You-Go State Pension system.

Where it is likely that the Funding Requirement will not be met (or worse still, where a deficit materializes), then the law will oblige the Scheme Administrator to levy additional contributions in order to remedy this shortfall.

Flexible Design and Full Transparency

Whilst as we have seen there is a need for adequate regulation, the Draft Law therefore takes the view that it should not unduly dictate the content of a Retirement Scheme. Benefits should very much correspond to what is promised in the Plan, with however a very important requirement in the form of a compulsory disclosure procedure for beneficiaries and contributors to enable them to monitor, either directly or indirectly, the Fund's management at all times.

Under the disclosure rules, we can for instance envisage that both employers and employees will have access to the following data prior to joining a Scheme and while they are members of it:

- The Retirement Scheme, including a full statement of the nature of the retirement benefit promise; Detailed contributions payable, Scheme benefits and how those benefits are secured; Details of the registered administrator, The criteria governing the valuation of assets and liabilities; The rules governing admissible costs and expenses; A general statement of the powers to make scheme amendments; The application of funds in the event of winding-up; A statement of the beneficiary's rights to further information and how this can be obtained.
- The Audited Accounts
- A Report providing information as is sufficient to enable an informed judgment on the development of the Fund and its financial performance.

Beneficiary's Right of Redress

The right of redress that is available to a beneficiary, whether current or future. An employee who is a beneficiary under an occupational retirement scheme is strictly speaking a third party to the contractual relationship between his employer and the Fund. As such his rights of action against the Scheme are indirect and unclear.

Such a situation is unsatisfactory, and the proposed law therefore provides that a Retirement Scheme, when duly notified to a beneficiary, operates as a binding arrangement between the Retirement Scheme and the said beneficiary, unless the latter opposes it within two months for a valid reason.

Of course, this right of redress is in addition to the beneficiary's right of action against his employer for breach of contract, whenever retirement rights are assumed under an employment relationship.

Tax Treatment

Saving through a retirement scheme means tying one's money up for a long period. Many countries have adopted a fiscal policy which provides incentives for individuals to overcome their natural reluctance to save. More significantly, tax advantages can make it more favourable for an individual to tie up his savings until retirement when he could otherwise invest in alternative savings vehicles where his money would be accessible whenever he wants it. The rationale is that if people do not give themselves an adequate income at retirement, they will put pressure on State Pensions at the expense of taxpayers in general.

It is not the purpose of this article to go into any detail regarding tax treatment. However we have already highlighted the fact that tax considerations will exert a powerful influence over demand of Maltese schemes by expatriates. Indeed whilst we have no control over the taxation of contributions from abroad, consideration will have to be given to the right level of tax that will be payable on investment income accruing to the Fund, and on the retirement benefits paid at source to retired beneficiaries.

Concerning domestic tax treatment, we are already aware of the arguments for tax incentives, and for the repeal of the present disincentive in the claw-back provision under the Social Security Act. These are issues that are beyond this article, but I expect that they will be raised for policy decision.

The tax system itself is an important, though not the only incentive for many people to save in a retirement scheme. Tax incentives should therefore be linked to Schemes which satisfy certain fundamental requirements, that have to be identified in the light of public policy. Minimum requirements would include the portability of such schemes as well as their affordability. Portability implies that an employee would be able to change employment without forfeiting his retirement benefits.

Affordability implies that charges have to be kept low and that there should not be high initial fixed costs that in effect tie an individual to a particular and possibly inefficient and uncompetitive fund management organization.