

Policy Document
of the
Malta Insurance Association
to the
Government
Pensions White Paper

28 April 2005

MALTA INSURANCE ASSOCIATION

POLICY DOCUMENT ON PENSIONS WHITE PAPER

OBJECTIVE

The Malta Insurance Association (MIA) is fully aware of the dangers, which threaten the sustainability of the pension system under current social security arrangements. In order to prevent the Maltese from falling into poverty during old age, it is essential that Maltese society as a whole makes a huge effort in saving more for retirement.

THE NEED FOR REFORM

The Malta Insurance Association therefore recognises this need for reform.

Indeed it has on various occasions drawn attention to the problems facing the first pillar pay-as-you-go (PAYG) pension scheme because of demographic developments — chiefly falling birth rates and increased longevity. As the number of workers shrinks and the pool of pensioners grows, our social security system came under clear strain.

The MIA also recognizes that this is not a Maltese phenomenon. The viability of state pension systems is seriously affected all over Europe.

THREE PILLAR SYSTEM

The Maltese Nation must therefore look to other economic possibilities as a means for complementing PAYG systems. Yet the Maltese are systematically deprived of (second pillar) occupational retirement schemes, because of a claw-back in state pensions, and are offered no fiscal encouragement when contributing to a (third pillar) personal pension scheme. So whilst Maltese employees are rightly worried by capped and increasingly insufficient state pension benefits, the local regime today prevents insurers and other financial services providers from playing their role in helping people save for retirement.

The MIA therefore agrees that people should have access to other products which help people save for retirement both through the workplace and individually. Second and third pillars are such products.

The MIA also calls for the removal of the claw-back provision in the Social Security Act.

MALTA INSURANCE ASSOCIATION

REGULATION UNDER THE SPECIAL FUNDS ACT

The argument that the private sector is not to be trusted in managing retirement funds has been rejected by the White Paper.

It is good to note that the White Paper reaches the conclusion that if the financial industry, through its local banks, insurers and investment service providers, enjoys good public confidence and credibility thanks to solid regulatory and supervisory regime, there is no reason why the same trust and belief cannot be gained by Retirement Scheme administrators operating within equally solid regulatory regimes.

The MIA agrees that state systems do not possess the expertise and technique to optimise capital investments. This is because social security systems are not managed as investment-based funds, but fiscal mechanisms which tax the income of workers with the aim of transferring it to pensioners. On the other hand insurers are technical experts in covering longevity risks, and with other financial services providers have the necessary investment know-how in both the provision of occupational schemes (2nd pillar) as well as in the provision of individual and optional pension welfare (3rd pillar).

So the MIA is also pleased that the White Paper recognises that the investment of such savings in financial assets and their availability upon retirement requires specialised investment and actuarial knowledge that is present with the various providers of financial services, but which is missing in the public sector.

The MIA recognises the wisdom of placing funded schemes under the regulatory regime of the Special Funds Act, under an independent supervisory authority of MFSA.

In this regard, the White Paper identifies a number of stringent policy criteria for the accreditation of Second Pillar providers. Many of these policy statements require detailed development.

The MIA expects MFSA to consult the industry in the elaboration of the accreditation criteria of Second Pillar products. For example the White Paper mentions that providers will need to have full time actuarial experts, whereas MIA believes that the local unavailability of this expertise would require a more realistic approach.

Insurers need to understand how the proposed scheme will respond to early retirement options and retirement as a result of ill-health. Insurers require insight to the investment management standards which will be allowed in the provision of Second Pillar retirement products. Insurers equally await the outcome of the actuarial study conducted for MFSA in connection to the parameters of a mandatory second pillar pension scheme. Individual insurers

MALTA INSURANCE ASSOCIATION

will be in a position to formalise their product proposals only after these parameters are made known.

MANDATORY or VOLUNTARY?

MIA shares the view that a voluntary funded pension system has very little chance of success since people will argue that the future will take care of itself. Moreover planned tax incentives will have a very limited impact on the low-end incomes that bear little, or no, taxation.

The White Paper also proposes that the Second Pillar should be introduced on a voluntary basis. MIA appreciates that an initial voluntary period gives elbowroom for development and adjustment of these proposals.

MIA however fears that the initial take-up of a voluntary funded system will not meet expectations, and the level of pension coverage amongst the various groups will be low. This will affect the nature of the product that pension providers will be able to make available, and may lead to dissatisfaction with the reform.

The reason for this is very much connected with economies of scale: the smaller the size of the fund, the more limited will be its investment potential and the higher the impact of costs. It is also due to the fact that we have no market for annuities in Malta, and at a time of low investment returns and increasing longevity, it will require a significant volume of “lives” and matching pool of assets to effectively kick start the development of this product.

When at maturity, aggregate savings are converted into an annuity, the insurer assumes a mortality risk. A balanced exposure to such risk is dependant on the law of large numbers. Insurers will look to the ideal of including in their portfolio, many similar and equivalent risks. In this way the mortality risk can be balanced collectively, meaning that premiums would fluctuate minimally as a result of random deviations in individual mortalities. A smaller basket of “lives” would mean that the insurance portfolio would be more sensitive to unexpected deviations, meaning that this will translate to a higher reinsurance cost to neutralize the poor balance.

MIA therefore urges that the Second Pillar Scheme should be introduced on a compulsory level with effect from such date as is agreed upon, without any intervening voluntary arrangement.

TAX INCENTIVES

MIA agrees that there must be adequate fiscal incentive to promote the transition from a public sector PAYG to one in which individuals will be required to pay an additional segment of their disposable income into funded pension schemes.

MALTA INSURANCE ASSOCIATION

The occasions at which taxation is possible are three.

- When money is contributed to the fund, normally by employers and employees;
- When investment income and capital gains accrue to the fund; and
- When retired scheme members receive benefits.

MIA supports the proposals in the White Paper that contributions into the fund from both employers and employees should be tax exempt. MIA would also expect that investment income and realised capital gains in a retirement fund would accrue without being subject to tax. The Association also agrees with the White Paper that taxation should be levied at point of payment of benefits at a fixed maximum percentage rate.

MIA disagrees with the White Paper in its fiscal proposals for the second tier of the Second Pillar Pension Scheme. The second tier is the option available to an individual who wishes to invest more into Second Pillar Schemes, on a range of schemes which could include widows' pension, invalidity pension etc, in the event that the individual would wish to increase the resultant benefit above the minimum statutory limit. The White Paper says that such additional investment flows should not benefit from tax relief.

MIA is not sure that it is good policy to discourage individuals from saving more, whether within these second tier Second Pillar Schemes or Third Pillar Schemes.

MIA is therefore proposing that qualifying retirement schemes under both the second tier Second Pillar Schemes and Third Pillar Schemes should also fall under an exempt, exempt, taxable (EET) system.

Moreover to provide a greater incentive for people to purchase annuities the tax rate on annuity income should not exceed the withholding rate (15%).

IMPACT ON PRESENT ENDOWMENT POLICIES

A lot of people have been saving for retirement by purchasing conventional endowment policies.

It is important that the benefits accruing from funded pensions should not be denied to owners of life endowment policies. Otherwise there is a real danger that policyholders will pull out of their present arrangements, and incur undesired losses.

The White Paper proposes that Life Insurers should allow owners of life endowment and similar policies to convert them into second Pillar pensions. MIA believes that this is another area where urgent consultations are necessary in order to prevent a run on these products.

MALTA INSURANCE ASSOCIATION

The conversion of existing endowment type policies to separate “pension policy” will result in an undue outgo from With-Profits Policies. Such outgo of policies will not be beneficial to policy holders if they incur surrender penalties. Alternatively the waiver of such penalties will result in a loss of acquisition expenses which are spread over the policy period. This will also jeopardise future surpluses (including embedded values) and future bonus rates.

A preferable approach¹ would be for existing policyholders to be given the option to hold their existing policies whilst benefiting from any new fiscal incentives on condition that they accept the new policy parameters applicable to Second or Third Pillar Schemes.

This can be achieved by laying down minimum qualifying conditions which have to be met before an existing endowment policy can qualify as a qualifying third pillar pension e.g.:

- a) Policy to mature at statutory retirement age;
- b) Maximum amount of premium on which the tax relief can be allowed;
- c) Limited or no surrender possibilities. If the policy is surrendered the tax rebates allowed would be recovered;
- d) At least x% (e.g. 75%) of Maturity value must be converted into an annuity otherwise the tax rebate will be recovered.

MALTESE INSURANCE INDUSTRY

The insurance market is a key sector of the economy and of the financial services industry in particular. In recent years there has been a sharp drop in the number of foreign insurers operating in Malta. The gap has been filled by local insurance companies who have continued to provide security to individuals and businesses throughout the country and to contribute significant tax revenues to the State.

- The domestic premium income of insurance companies in 2003 was approximately **Lm85 million** (5% of GDP).
- Insurers are major investors in the Maltese economy, with significant holdings of Government stock, equities and property.
- In 2003, over **Lm26 million** were paid in life assurance benefits and non-life insurance claims, whereas a further **Lm28 million** have been provided for additional outstanding claims.

¹ British American Insurance Co. (Malta) Ltd. and Citadel Insurance Plc do not share this position. They are of the opinion that holders of Life Endowment Policies should be offered the option to convert their policy to a Second Pillar pension product. They believe that in keeping with the portability principle, individuals should be able to change their life assurance provider without additional costs or conditions.

MALTA INSURANCE ASSOCIATION

- MIA member companies employ **over 900 people** directly; in addition they are responsible for more than 550 insurance sub-agents, with hundreds more employed in ancillary services such as insurance broking, insurance surveying, risk management and loss adjusting.
- In 2003, MIA members covered over **Lm7 billion** worth of property insured in Malta. That included residential buildings as well as commercial, industrial, hotelier and engineering risks.
- In 2003, MIA members paid over **Lm4 million** in document duty to Government.

The Malta Insurance Association (MIA) represents life and non-life insurance companies in Malta. MIA unites all eight indigenous Maltese insurance companies as well as ten of twelve foreign insurers transacting business in Malta. Member companies write over 96% of all life and non-life insurance business in Malta. MIA members are listed hereunder:

American Home Assurance Co.
Atlas Insurance Ltd.
British American Insurance Company (Malta) Ltd
Gasamamo Insurance Ltd
Citadel Insurance plc
Ecclesiastical Insurance Office plc
Goudse Verzekering Maatschappij N V
HSBC Life Assurance (Malta) Ltd
Middlesea Insurance plc
Middle Sea Valletta Life Assurance Co. Ltd.
Norwich Union International Insurance Ltd.
AXA PPP Healthcare Ltd.
Qatar Insurance Co.
Elmo Insurance Ltd.
Societa' Italiana Assicurazioni e Riassicurazioni S.p.A. - S.I.A.T.
BUPA Insurance Ltd
Exeter Friendly Society
SOVAG. - Schwarzmeer Und Ostsee Versicherungs-Aktiengesellschaft.
Victoria Insurance Agency Ltd
Allcare Insurance Agency Ltd
England Insurance Agency Ltd
Rausi Insurance Agency Ltd and Unipol Insurance Agency Ltd
Millenium Insurance Agency Ltd

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