BOX 3: AN INTRODUCTION TO PENSION FUNDS REGISTERED IN MALTA[1]

Introduction

Pension funds play an important role in ensuring financial security for households during retirement while contributing to the stability of the financial system. They also facilitate the efficient allocation of long-term capital across firms. As the population ages, pension funds are becoming increasingly important domestically, emphasising the need for sustainable retirement income. Pension funds pool contributions from individuals, employers or any other participants, and invest them in a diversified portfolio of assets with the aim to generate long-term returns. This approach provides retirees with a steady income stream, while simultaneously supporting economic growth, influencing capital markets, and contributing to financial market resilience.

The turbulence in the UK Gilt Market in late September 2022 underscored the significant role pension funds play as active market participants, demonstrating how the sector's development can potentially trigger and amplify market volatility during periods of financial stress. While the private pension system in Malta is still evolving, estimates from financial accounts data shows that these remained very limited at just 0.11% of overall financial assets.[2]

This Box aims to discuss the growth of Malta-registered pension funds, shedding some light on their potential financial stability implications.

Overview of the pension funds sector

Between 2019 (when pension funds data first became available) and 2024, the number of domestically registered pension funds remained roughly stable, amounting to 48 as at June.[3] Of these, 45 were classified as non-occupational schemes, which are set up independently with voluntary contributions that are not tied to any specific employment. The remaining three were categorized as occupational pension funds, which are provided by employers, with contributions made by both parties of the employment relationship. In terms of size, non-occupational pension funds hold most of the assets managed by the sector, standing at around 98.7% of the overall assets. All these funds are defined contribution (DC) pension schemes, where members contribute to a fixed amount or percentage of income to an individual account and the final benefit depends on the contributions made and the overall investment performance.[4]

Despite the limited developments in the number of pension funds registered, these still expanded their presence, both in terms of overall assets as well as participation.

Between 2019 and 2023, the sector registered over 25% increase in the number of members enrolled (see Chart 1). Growth, however, diverged among the composition of such members. Active individual members grew by 88.5%, to account for 46.0% of overall membership, from 30.7% in 2019. Retired members, being those receiving regular pension payments from the fund, also grew, up by 51.1% and accounted for 30.2% of overall members. In contrast, deferred members, who are those that stopped contributing but are yet to draw their pension benefits fell to account for around 23.8% of the overall members, compared to 44.3% in 2019.

[1] Prepared by Mr Renan Dos Santos Carinha, Analyst, from the Financial Stability Surveillance Office. The author would like to express his gratitude to Mr Andrew Spiteri, Manager within the same office, and Ms Wendy Zammit, Head of the Financial Stability Surveillance and Research Department, for their invaluable suggestions.

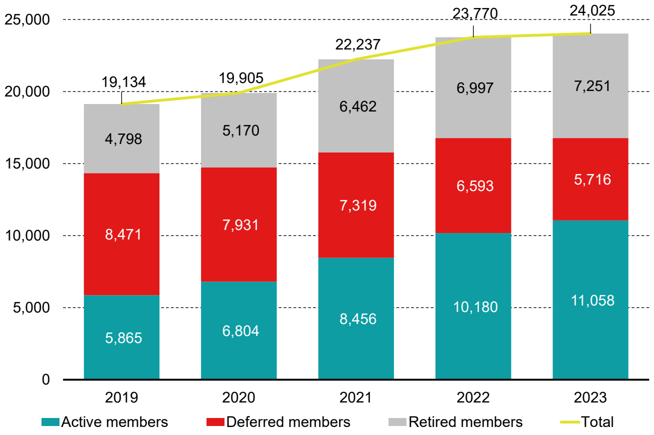
[2] Source: ECB.

[3] Out of these 48 pension funds, 46 are licenced as Retirement Schemes, with the remaining two licenced as Retirement Funds.

[4] Another type of fund commonly found in other EA countries is the defined benefit plan, which guarantees a specific retirement benefit, based on factors other than the investment performance. Nevertheless, there are no pension funds currently registered in Malta operating under this scheme.

The change in the composition of the members resulted in the active-to-retired members ratio rising from 1.22 in 2019 to 1.53 in 2023, suggesting the pension funds' increased ability to sustain payouts with ongoing contributions. Concurrently, the active-to-deferred ratio stood at 1.9, growing steadily since 2019. This also indicates that pension funds are increasingly reporting higher inflows of contributions compared to their future liabilities, which is the deferred pensions. By the end of 2023, about 85% of overall members were non-resident. Despite the limited domestic participation, since 2019, the number of domestic members has grown exponentially, up by more than eightfold. As a result, their share of the total membership has risen by 12.7 percentage points compared to 2019. This increase is driven by the growing interest in pension plans by domestic households, possibly also driven by the tax benefit schemes on offer.[5] The rise in domestic members was almost exclusively among active members, where just over a third are resident. In contrast, non-resident beneficiaries accounted for all the retired members and represented 98.1% of the total deferred policyholders. Nonetheless, it is worth noting that resident members are entirely concentrated in four pension funds, which currently have no retired members.

Chart 1
AMOUNT OF PENSION FUNDS MEMBERS BY TYPE
(value)

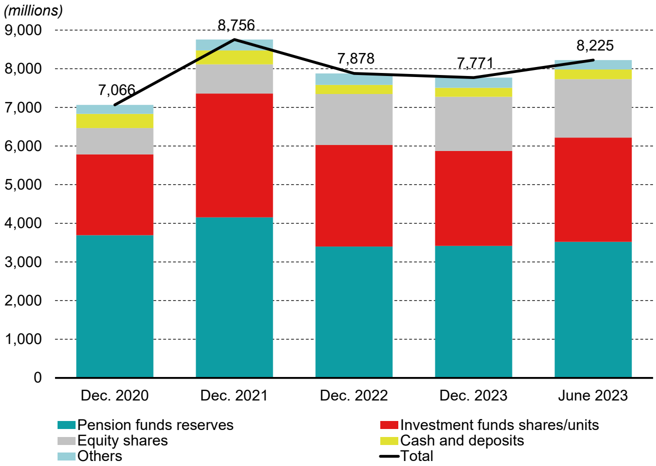


Source: Central Bank of Malta.

Assets and liabilities composition

The increased interest in pension funds in the last few years meant that their overall assets grew by nearly 20% between end 2019 and June 2024. Total assets under management (AUM) by the domestic pension funds reached over €8.2 billion in mid-2024, equivalent to around 38% of GDP (see Chart 2). Overall assets held by pension funds peaked in 2021 at €8.8 billion. In the subsequent two years the assets held by pension schemes declined owing to

Chart 2
DOMESTIC PENSION FUND'S ASSET SHARES
(millions)



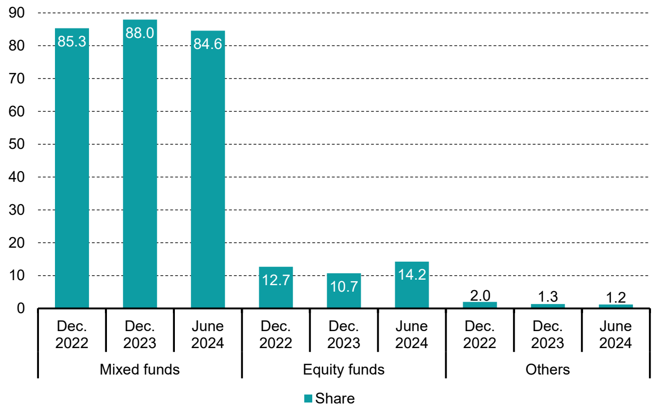
Source: Central Bank of Malta.

[5] An annual tax credit of 25% on a contribution ceiling of a maximum of €3,000 is available. This means that a maximum annual tax credit of €750 can be obtained. Source: Buying private pension retirement products.

the monetary tightening and the decline in financial markets. Nevertheless, recent results have demonstrated robust growth with the aim of recovering from the losses registered. As a result, the overall value of total assets expanded by 5.8% during the first half of 2024.

The composition of the overall assets remained relatively stable during the period assessed. Pension funds' reserves were consistently the main asset component, standing at 42.8% of overall assets by June 2024. These consist of a pool of assets which reflect the contributions, the investment returns and any adjustments due to market performance which are set aside to ensure that pension funds can meet their future obligations to retirees and other beneficiaries. Such reserves act as a safety net to manage the risk of underfunding, which could happen if contributions and investment returns are insufficient to cover future pension liabilities. These are followed by holdings of investment funds units which accounted for 32.8% of the balance sheet by June 2024. The vast majority were allocated towards non-MMFs categorized as mixed funds (see Chart 3). Equity sub funds followed with 14.2% as the remaining were limited to just 1.2% of the share.

Chart 3
INVESTMENT FUND HOLDINGS BY TYPE
(per cent)



Source: Central Bank of Malta.
Note: Others include holdings of Other Allocation Funds, Bond Funds, Hedge Funds and Real Estate Funds.

Meanwhile, direct equity exposures stood at 18.4% of the overall asset holdings as of June 2024. Cash and deposits represented just 3.0% of the total assets, while on aggregate, other assets such as loans granted, debt securities held, and non-financial assets remained together limited to around 3.0%.

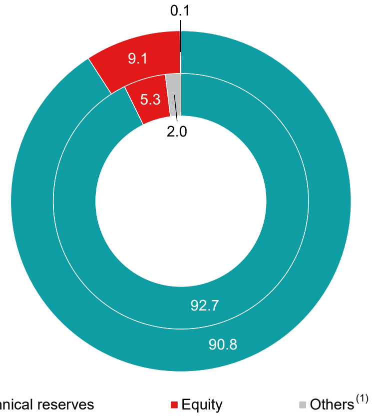
Nonetheless, it is worth noting that although the direct holdings of debt securities were limited, the exposure of the pension fund sector to the fixed-income market remained present largely through the holdings of mixed investment funds units.

In terms of geographical exposure, the largest share of assets were securities issued by entities based in countries other than the euro area, the vast majority situated in British Crown Dependency territories, the United States and the United Kingdom, representing around 63% of the total assets by mid-2024. Parallel to that, euro area accounted for 25.4% of the overall assets. Meanwhile, domestic assets were limited to 12.0% of the overall portfolios, largely in equities.

Pension funds' technical reserves, which are the estimated present value amount required to cover future pension obligations to policyholders, account for most of the liabilities (see Chart 4). In line with the balance sheet developments, following the decline reported in 2022 and 2023, such reserves rose by 5.4% during the first half of 2024, accounting for 90.8% of total liabilities. The remaining 9.2% of liabilities consisted almost entirely of equities, which share increased during the period assessed.

Geographically, the largest part of technical reserves' entitlements was towards beneficiaries based in the euro area, which accounted for 40.0% of the total share. Entitlements from the rest of the world represented 39.2% of all technical reserves, most notably with policyholders predominantly based in the United Kingdom. Concurrently, US residents represented 20.1% of the total technical reserves. Maltese beneficiaries were limited to 0.7% of the total entitlements.

Chart 4
COMPOSITION OF PENSION FUNDS LIABILITIES
(per cent)



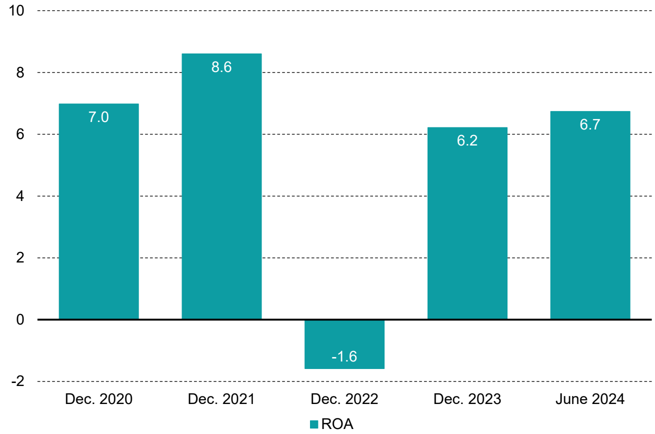
Source: Central Bank of Malta.
(1) Loans, other payable.

Key financial metrics for pension funds

This section introduces a number of metrics which are key for evaluating the financial health and performance of pension funds in meeting their long-term obligations to beneficiaries. These include the funded ratio, which compares the fund's total amount of assets to its liabilities. It indicates the fund's ability to meet its pension obligations. A ratio above 100% indicates that pension funds have a solid position to meet current and future obligations to their members. During the period assessed the funded ratio remained relatively stable, reaching 110% in June 2024. In comparison, pension funds in the euro area reported a higher funded ratio of 123%[6] for the same period.

When looking at the contribution-to-benefit ratio, which measures the balance between the contributions made into the fund by its active members to the benefits being paid out to its retired members, data for 2023 indicates a healthy ratio standing at 1.4. This ratio indicates that the flow of contributions significantly exceeded the benefits currently being paid out. During the first six months of 2024, the contribution-to-benefit ratio registered a slight increase to 1.5. These high ratios, however, also point to the fact that pension funds are still in their infancy, reflective of the fact that they have limited retirees.

Chart 5
RETURN ON ASSET
(per cent)



Source: Central Bank of Malta.

Data available from 2020 shows that pension funds were generally profitable, as highlighted by the ROA, which is measured as the four-quarter moving sum of profits or losses as a share of the average AUM (see Chart 5). The only exception was in 2022. However, profitability quickly recovered

6 Source: ECB.

along with the gains observed across financial markets by the end of the third quarter of 2023. By mid-2024 the ROA stood at 6.7%.

Meanwhile, the expense ratio,[7] which measures the evolution and performance of operating and management costs of pension funds as a proportion to their total assets, increased marginally since 2020, standing at 0.58% in June 2024. Such a level generally points towards moderate expenses.

The rate of return for pension funds is defined as:

$$Rate\ of\ Return = \frac{Net\ Return}{Beginning\ Value\ of\ Fund} x\ 100$$

Where: Net Return = Ending Value of Fund - (Beginning Value of Fund + Contributions – Withdrawals)

Using this metric, pension funds recorded a negative return of 2.8% for 2023, mainly reflecting lower valuations of overall assets coupled with net withdrawals. However, the positive performance of financial markets prompted a significant expansion in assets with the rate of return rising to 4.6% in the first half of the year.

Liquidity

The primary liquidity risk for pension funds arises from the potential inability to meet short-term obligations, particularly benefit payments, without the risk of selling assets at a loss due to insufficient liquidity. However, in June 2024, the aggregate indicators such as the active-to-retired members and the contributions-to-benefits ratio support a positive outlook for the sector in the medium term. In addition, assets are primarily composed of relatively liquid assets, including technical reserves, investment funds units, and shares.

Outlook

The consistent growth in membership and assets of domestically-registered pension funds underscores the sector's resilience and its potential for further development. While most members were non-residents, the share of resident members has been steadily increasing throughout the years. This presents a promising opportunity for ensuring financial security in retirement, particularly in the face of an ageing population and increasing demand for sustainable income solutions, serving as another important component for the broader social safety net.

Positive metrics, such as the funded ratio and contribution-to-benefit ratio, indicate that the funds are well-positioned to meet their obligations. The challenges posed by market volatility, as seen in recent years, highlight the necessity for prudent investment strategies and regulatory analysis. With units in investment funds comprising more than a third of total assets, pension funds need to keep watch for potential exposures to risks and vulnerabilities originating from the funds industry, such as liquidity mismatches and leveraged portfolios. The profitability and the rate of return has started increasing again, consolidating the rebound of the sector from the losses experienced in previous periods.

As the private pension system continues to mature, accompanied by increased domestic participation, ongoing monitoring of the key indicators is essential in assessing this sector long-term stability and sustainability in Malta.

[7] The expense ratio includes expenditures listed as administration expenses, investment advisory fees, investment management expenses, legal and professional fees, bank charges, custodian fees, and trustee expenses. It does not include disbursements listed as taxation and other expenses.