Original Article

Pension regulation in Malawi: Defined benefit fund or defined contribution fund?

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ABSTRACT This article examines and comments on the provisions in the Pension Act, which make it mandatory for every employer and employee to contribute towards a pension fund in Malawi. It discusses the provisions that govern the exemption of certain employees from the Pension Act. The article examines Section 15 of the Pension Act, which compels every employer to maintain a life insurance. The article argues that the Pension Act promotes defined contribution funds and offers four reasons for this contention, which are: the prescription of minimum contributions to be paid into the fund; the ease of portability of benefits; the legislative establishment of individual accounts; and the provision of tax incentives to employees. The article observes that due to that fact that the Pension Act makes it expensive to operate a defined benefit fund, Malawi is likely to see the demise of these types of fund.

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INTRODUCTION

In 2011, the legislature in Malawi passed the Pension Act 6 of 2011 and the Employment Amendment Act 27 of 2010 concurrently to specifically resolve two important application problems. The first problem was the double burden on employers, who operated running voluntary pension schemes for their workers and were required to pay severance allowance as well as pension benefits upon the termination of employment.¹ The second problem was the widespread income insecurity on retirement

for the majority of Malawians. The two Acts clearly separate the circumstances under which pension or severance is applicable. In brief, pension entitlement is now governed by the Pension Act, whereas severance entitlement is governed by the Employment Amendment Act. Under these reforms, severance allowance is no longer payable on retirement or death of the employee or incapacitation as was the case previously.² Instead, benefit entitlement arising from retirement, death or incapacitation are now governed by the Pension Act. However, severance allowance is now only payable on termination of employment due to economic or operational restructuring and unfair dismissal in terms of the Employment Act as amended.³ Section 4 of the Pension Act

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delineates the objectives of the Pension Act, which are:

The objectives of this Act are to:

- (a) ensure that every employer to which this Act applies provides pension for every person employed by that employer;
- (b) ensure that every employee in Malawi receives retirement and supplementary benefits as and when due;
- (c) promote the safety, soundness and prudent management of pension funds that provide retirement and death benefits to members and beneficiaries; and
- (d) foster agglomeration of national savings in support of economic growth and development of the country.

The Pension Act represents a paradigm shift in the regulation of pension funds in Malawi. It makes it mandatory for every employer and employee to contribute towards pension fund. Further, it compels every employer to maintain a life insurance policy on behalf of every employee.

This article examines on the provisions in the Pension Act, which make it mandatory for every employer and employee to contribute towards a pension fund. It discusses the Pension (Salary Threshold and Exemptions) Order 2011 (herein as Pension Order), which provides for the exemptions of certain employees from the Pension Act.⁴ After examining other provisions of the Pension Act, the article also examines Section 15 of the Pension Act, which compels every employer to maintain a life insurance. The article argues that the Pension Act promotes defined contribution funds as opposed to defined benefit funds. It offers four reasons for this contention, which are: the prescription of minimum contributions to be paid into the fund; the ease of portability of benefits; the legislative establishment of individual accounts; and the provision of tax incentives to employees. Further, the article argues that the Pension Act will likely lead to the potential demise of defined benefit funds.

EXAMINING THE COMPULSORY PENSION AND DEATH BENEFITS PROVISIONS IN THE PENSION ACT

Compulsory pension benefits provisions

The primary purpose of the Pension Act is to ensure that an employer to which this Act applies provides pension for every person employed by that employer. To achieve this policy objective, Section 6 stipulates that:

- (1) There is hereby established a contributory National Pension Scheme (in this Act otherwise referred to as the 'National Pension Scheme') for the purpose of ensuring that every employee in Malawi receives pension and supplementary benefits on retirement.
- (2) The National Pension Scheme shall comprise:
 - (a) a national pension fund to be established under this Act, by the Minister, by Order published in the *Gazette*; and
 - (b) other pension funds licensed under this Act
- (3) Every employer shall make provision for every person under this employment to be a member of the National Pension Scheme.

The above section should be read together with Section 9, which provides as follows:

- (1) Subject to Section 10, every employer shall make provision for every person under his employment to be a member of the National Pension Scheme.
- (2) The Minister responsible for labour and the Registrar, in consultation with the Minister, shall be responsible for ensuring compliance with this part.
- (3) Any employer who, without reasonable excuse, fails to comply with this section shall be liable to administrative penalties under the Financial Services Act, 2010.

On the basis of the above provisions, the employer is required to facilitate employee's membership of the national pension scheme. This essentially requires that an employer must ensure that his employee becomes a member

of either the national pension fund (which covers all civil servants) or any other registered pension fund.⁵ Further, as discussed in detail below, once an employee becomes a member of the national pension scheme, the Pension Act defines the minimum pension contributions that he and his employer must pay into the pension fund. According to Section 12(1), the employer and employee are required to contribute 10 and 5 per cent of their salaries, respectively, towards the pension fund.

However, the Pension Act is not applicable to every employer or employee. Section 10 governs the scope of the Pension Act, and prescribes exemption requirements. It confers discretion on the Minister of Finance in consultation with the Minister of Labour and the Registrar of Financial Institutions (Registrar)⁶ to prescribe, by order in the *Government Gazette*, a salary threshold by which an employer or employee will be exempted from complying with the requirements in Sections 9 and 15 of the Pension Act. Section 10 of the Pension Act has to be read together with Section 6(3) of the Employment Amendment Act 27 of 2010. The latter provision provides that 'an employer whose employee's monthly salary is below ten thousand kwacha may be exempted from complying with the provisions of the Pension Act'.⁷

The Minister of Finance recently exercised his authority pursuant to Section 10 of the Pension Act and issued the Pension Order.⁸ The Pension Order is significant because, first, it exempts certain employers from complying with certain provisions of the Pension Act. Section 3 of the Pension Order stipulates that 'an employer whose employees' monthly pension emoluments is K10000 or less shall be exempt from complying with the requirements of Sections 9 and 15 of the Act'.⁸ Second, the Pension Order exempts a class or category of employees and employers from the Pension Act. Section 4 of the Pension Order exempts seasonal workers,⁹ tenants,¹⁰ expatriates in possession of a temporary employment permit,¹¹ members of parliament in their capacity as such and domestic workers from complying with the provisions of the Pension Act.

There has been a mixed reaction to the Pension Order among legal commentators. Some commentators have observed that since seasonal workers, tenants and domestic workers form a considerable part of the labour force in Malawi, to exempt them from the Pension Act could defeat the objectives of that Act which is to cover as many employees as possible.¹² On the other hand, others have observed that the exemptions are provisionally essential given the difficulties of administering pension schemes for seasonal workers, tenants and domestic workers.¹³ While there is merit in both observations, the article strongly agrees with the latter observation that in the future fewer employers and employees will likely be exempted. It is also apparent from Section 4(a) of the Pension Act that the legislature contemplated that the Pension Act would not apply to every employer. The words 'every employer to which this Act applies' clearly reveal a legislative desire to exempt certain employers from the Pension Act.

Although the purpose of the Pension Order is to determine whether or not an employer and/or employee is exempted from the Pension Act, there are two important exceptions. The first exception is contained in Section 10(2)(a) of the Pension Act, which provides that where an employer employs five employees or more that employer must provide a pension for those employed regardless of whether the salaries of those employees fall below the prescribed salary threshold.

The second exception is in Section 10(2)(b) of the Pension Act and provides that any employer who has an existing pension scheme at the commencement of the Pension Act will be required to ensure that every employee who was a member of such pension scheme continues to be a member regardless of the salary threshold. It is clear that these exceptions to the Pension Order are designed to ensure that more employees in Malawi are covered by the pension legislation in line with the objectives of the Pension Act. Moreover, the Pension Act itself exempts any employee, who from the date that Act became enforceable was entitled to pension benefits and has 3 or less years until

the retirement date from complying with the Pension Act.¹⁴ Apart from making pensions compulsory, the Pension Act mandates employer to provide certain risk benefits.

Risk benefit provisions

The legislature in Malawi recognized that the provision of pension benefits would not be sufficient to address the risk of widespread income insecurity. It accepted that the death of an employee can present similar risks of widespread income insecurity to the dependants or close relations of the deceased employee as the lack of pension savings does. As a result, the legislature decided to compel every employer to maintain a life insurance policy for every employee to address the widespread problem of income insecurity and to increase the number of Malawians who are insured. This policy decision is reflected in Section 15, which makes it compulsory for every employer to maintain a life insurance policy of the same value the annual pensionable salary as every employee. Under this arrangement, when a member dies, Sections 15 and 72¹⁵ of the Pension Act require that the proceeds of this life insurance policy must be paid into the deceased member's pension fund account and distributed to the dependants and/or close relations of the deceased member in accordance with the provisions in Section 71. This section, which regulates payments of death benefits,¹⁶ provides that the death benefit must be paid in accordance with a nomination made by the member. In the absence of a valid nomination, Section 71 gives the trustees discretion to pay the dependants of the deceased. It has been argued elsewhere that there is a social protection policy that underpins Section 15 read with Sections 70 and 71 of the Pension Act in general.¹⁷

According to this argument, the policy aim is to reduce the financial burdens on the state by promoting people's ability to support themselves; that Section 15, by prescribing mandatory life insurance, contributes to the broader social policy of ensuring that dependants and close relations of the deceased employee are not left destitute on the death of an employee. Once received, these

benefits will enable them to support themselves financially and have access to health care, education and other services, and allow them to contribute to the economic development of Malawi.¹⁸ Accordingly, this is one way in which the Pension Act promotes economic growth and development.¹⁸

DISCUSSING THE PROMOTION OF DEFINED CONTRIBUTION FUNDS IN THE PENSION ACT

A brief discussion of defined benefit funds and defined contribution funds

It is the main contention in this article that the Pension Act promotes defined contribution funds as a preferred type of pension fund design for Malawi.¹⁹ Although pension funds are complicated and come in numerous designs, there are a few basic principles of pension fund design that are important to the discussion of the main contention in this article. Specifically, it is important to understand the differences between defined benefit funds and defined contribution funds and their characteristics. In the discussion that follows, the article briefly discusses these characteristics.

There are two fundamental types of pension funds designs: defined benefit fund and defined contribution. A defined benefit fund promises a fixed monthly benefit at retirement. The pension fund rules may state the promised benefit as an exact amount, such as US\$700 per month at retirement. Most defined benefits funds calculate benefits through a formula involving the employees' service and salary histories.²⁰ While pension fund rules are diverse, the general formula used most by defined benefit funds entitles a pension member to a fixed income equal to a percentage of the employee's final average salary, multiplied by the number of years of employment.²¹ Commentators have observed that defined benefit funds are more advantageous to employees who spend many years working for a single employer.²² One of the reasons for this phenomenon is that it manifests an employer's yearning to retain employees, who have acquired valuable skills, by designing defined benefits

funds to provide generous benefits to such long-term serving employees than to employee following other career paths.²³ Another observation is that defined benefit funds manifests the traditional view that investment management and financial risks are effectively managed by employers than employees.²⁴ Professor Eriksson goes as far as to suggest that under defined benefit funds the employer's responsibility is not only to duly contribute but also manage the fund.²⁵ The reason for the employer's heavy involvement is that the employer alone bears the investment risk. If a defined benefit fund investment performs imperfectly, the employer remains liable to pay the promised benefits. In other words, while employees enjoy fixed benefits in defined benefit funds, the future cost to the employer remains uncertain.²⁶ Hence, it is in the employer's interest for the fund to be effectively managed.

Conversely, defined contribution funds do not promise a fixed or specific amount of benefits at retirement. Instead, the employer and employee contribute to an individual pension fund account under the fund. Contributions may vary or set at an agreed rate, such as 5 per cent of an employee's salary. In Malawi, the contribution rates are prescribed in the Pension Act, where an employer's only obligation is to make the prescribed contribution to the employee's account. Hence, it is fair to say that defined contribution funds are always fully funded.²⁷ Once received, pension contributions are invested by the board of the pension fund and the employee ultimately receives the account balance, which is based on contributions made and investment gains or losses. Accordingly, employees personally assume the hazard of investment volatility in defined contribution funds. If the investment is bad, the amounts received at retirement will be diminished. If the investment is good, the employee's benefits increase.

Unlike defined benefit funds, defined contribution funds manifest the crave by employers to limit long-term financial commitment and shift in employer's primacies away from retaining employees with eroding skills to attracting employees with new and improved skills.²⁸ As a

result, defined contribution funds tend to attract mobile employees because they are more adaptable to the needs of employees who follow other career paths.²⁸ Given the cost-effectiveness of defined contribution funds, smaller employers tend to prefer these funds to avoid long-term financial commitments and administrative complexities associated with defined benefit funds. As should be comprehensible from the foregoing analysis, the main characteristic of a defined benefit fund is that an employee's benefit is fixed, while this is not the case in a defined contribution fund.²⁹ In the next section, the article argues that the Pension Act promotes defined contributions funds.

DEFINED CONTRIBUTION FUND PREFERRED UNDER THE PENSION ACT

As mentioned above, it is my main contention that the Pension Act envisages and promotes defined contribution fund. In the discussion that follows, the article provides four legislative basis for this main contention. First, one of the most important characteristics of a defined contribution fund is that it defines the minimum pension contributions that employers and employees must make.³⁰ The higher the amount of pension contributions the employer and employee contribute into a pension fund coupled with strong investment performance, the higher the benefit due to the employee on retirement or to the beneficiaries on the death of the employee. The expected minimum pension contribution rates from the employer and employees are prescribed in Section 12(1)(a) and (b) of the Pension Act, respectively. Under Section 12(1)(a), the employer is required to contribute a minimum of seven and half per cent for the first 2 years of coming into operation of the Pension Act, and thereafter 10 per cent of the employee's salary to the pension fund on behalf of his employees. This 2-year period runs from June 2011 to June 2013. It denotes that from June 2013, every employer will be required to contribute 10 per cent towards an employee's pension. Further, employers are permitted to unilaterally contribute 10 per cent towards an employee's pension before the June 2012

deadline. In addition, Section 12(1)(b) requires the employee to contribute 5 per cent of his salary towards his pension fund.

The Pension Act encourages an employer or employee to contribute more than the prescribed minimum pension contribution rates. This is evident from Section 12(2), which provides that the minimum pension contribution rates prescribed in Subsection (1) of the same provision may be revised upwards by agreement between an employer and an employee. This means that Section 12(2) permits a collectively bargained agreement between the employer and employee to, for instance, contribute 23 per cent and 5 per cent, respectively, towards the pension fund. Moreover, Subsection (3) permits the employer to agree or elect to bear the full burden to pay the total pension contributions on behalf of the employee such that pension funding becomes non-contributory to the relevant employee provided the employer contributes at least the total minimum pension contribution of 15 per cent. In other words, Section 12(3) permits the employer to pay all contributions including on behalf of every employee.

In addition, Section 12(4) provides that an employee may make extra voluntary contributions (beyond the compulsory 5 per cent) towards any pension fund to which the employer of that employee is currently contributing. It is important to point out that Section 12(4) is most relevant in a defined contribution fund context where, as pointed out above, the achievement of an enhanced benefit at retirement is measured solely on the basis of the contributions and investments performance. Put simply, extra pension contributions by a member of a defined contribution fund can enhance the benefit that such member receives at retirement.

It is for this reason that most defined contribution funds, including those who have recently shifted from a defined benefit to a defined contribution arrangement, encourage their members to make extra voluntary pension contributions. The Botswana Public Officers Pension Fund (BPOPF), which in 2001

converted from a defined benefit to a defined contribution arrangement, has in the last couple of years embarked on a campaign to encourage its members to make extra voluntary contributions. In the 2011 BPOPF Newsletter known as *Peeletso*, the BPOPF explains to its members the benefits of making extra voluntary contributions as follows:

Every pensionable employee working for the Government of Botswana is required to contribute 5 per cent of their salary and the Government contributes 15 per cent of their salary towards building the employee's retirement package. However, the employee can contribute up to an additional 10 per cent tax free, when they want to enhance their retirement package. One of the fundamental principles that is often neglected is the principle of putting a little bit more of your money aside to work harder for your future. By a little bit more of your money we refer to increasing your pension contributions above the normal expected contributions and by working harder we refer to investing for a longer period. The combination of a little bit more of your money and working harder are factors under your control to give yourself an added advantage in achieving a dignified post career life.³¹

What is significant is that the government of Botswana has adopted tax policies to promote pension savings, which complements the campaign of the BPOPF. These policies provide tax incentives to employees who make extra voluntary pension contributions.³² On the contrary, extra voluntary contributions in a defined benefit environment are typically not required or accommodated, but even if they were it would make no significant difference to the employee because benefits promised at retirement are fixed and the employer assumes the responsibility to pay them.

Second, the Pension Act promotes defined contribution funds by enabling with ease the transfer of benefits from one pension fund to another. Sections 14 and 44 of the Pension Act are significant in this regard. They permit an employee to transfer pension benefits to another pension fund or switch membership of pension

funds. The two provisions provide in pertinent parts as follows:

s 14 An employee may transfer pension benefits accruing to his account to any unrestricted fund without giving any reason for the transfer, and upon such transfer the employer of that employee shall redirect the contribution that he is required to make under section 9 to the fund selected by the employee.

s 44(1) The fund rules of a pension fund that is a restricted fund shall provide that (a) if a member, continuing in employment with the employer, applies to switch to a registered unrestricted fund, the trustee shall pay the amount of the member's benefits in the fund to the trustee of the specified pension fund.

The ease of transferability of benefits by employees in the case of a defined contribution fund is one of the characteristics of this type of fund that makes it most attractive to employers, mobile employees and policymakers. This is made possible by the fact that funds are mostly made up of individual accounts, which, like bank accounts, are transferable from earlier to new employers without any complexities.³³ The advantage, from the employees' point of view is, according to some commentators, that benefits in these types of funds accumulate more evenly through their career and are entirely moveable should the employees separate from the sponsoring employer or leave employment for a period of time.³⁴ In his study of the problems with pension portability (namely the ability of employee to carry their pension benefits with them as they change jobs), Professor Willborn observed that the ability of employees to transfer the assets of defined contribution funds between employers when they change employment does not involve increased costs or benefits.³⁵ Apparently, this is why the ability to transfer pension benefits during job changes is positively associated with defined contribution funds.

On the contrary, Williborn argues that for defined benefit funds, portability raises administrative and technical challenges relating to operations of the fund overall.³⁶ In his view,

generally defined benefit funds pay benefits over a period of time commencing at the workers retirement, rather than a lump sum at some earlier time; and that if portability required previous employers to make lump sum payment to new employers at the time the employee transfers, defined benefit funds could face cash flow problems. In intense cases, he observes, funds could be forced to disinvest at inopportune times.³⁷

A further potential problem of portability affecting defined benefit funds is that job changes often reduce pension benefits in these types of funds as expected pension benefits normally accrue only to employees who stay with their employer throughout their career.³⁸ This is not surprising because one of the main incentives for being a member of a defined benefit fund is that long-term tenure is rewarded.³⁹ However, the number of mobile employees is increasing across the globe and the reduction of pension benefits in the event of job switching is a serious detriment for employees in all societies.⁴⁰ Consequently, defined contribution funds are common and beneficial for mobile employees. As the transfer of benefits is advantageous to defined contribution funds and not defined benefit funds for the reasons mentioned above, it is my submission that the inclusion of Sections 14 and 44 in the Pension Act is another deliberate legislative policy to encourage defined contribution funds in Malawi.

Third, Section 11 of the Pension Act requires pension funds to establish individual accounts. This requirement is relevant in defined contribution funds because these funds are made up of individual accounts where employees and employers contribute pension savings.⁴¹ As discussed above, in a defined contribution funds, an employer promises only to make a fixed contribution into an account established for each employee. The amount of the employee's benefit at retirement will depend entirely on the amounts contributed into his individual account and on investment performance. Thus, it is significant that the Pension Act requires the establishment of individual accounts, which bear the most importance in defined contribution

funds. Even if the Pension Act had not prescribed the establishment of individual accounts, the nature and character of defined contribution funds requires individual accounts and these accounts would be established regardless. Therefore, the inclusion of Section 11 in the legislative framework points to the desire by the legislature to promote defined contribution funds in Malawi.

Fourth, the provision of tax incentives to employees and employers who participate in a pension fund is one of the critical policy instruments used to promote pension savings. As noted above, the government of Botswana employs tax legislation to encourage extra voluntary pension savings by providing a tax incentive of up to 10 per cent for pension contributions.⁴² In Malawi, Section 13 of the Pension Act seeks to achieve similar objectives. It provides that all pension contributions by the employer and employee to any pension fund are tax deductible. However, when the Pension Act came into force in June 2011, Section 13 was suspended from implementation to allow for a review of the entire tax system. This review was conducted during the financial year 2011/2012. In his 2012/2013 budget statement, Minister of Finance Dr Ken Lipenga announced that Section 13 of the Pension Act would be amended to make reference to the Taxation Act, where a new structure for taxation of pension will be introduced. While these reforms in the taxation of pensions have not yet been passed into law, the Minister hinted that the reforms will be crafted in such a way that pension contributions by the employee will be net of taxes, and contributions by the employer will be deductible up to 15 per cent of the employee's annual salary.⁴³ Further, earnings from pension investments will be taxed at a rate of fifteen per cent.⁴³ He added that pension benefits that accrue to the pensioner will be exempted from taxes. These policy statements are reflected in the Taxation Amendment Bill 22 of 2012. Section 12 of this Bill provides that:

'The amount to be allowed as a deduction to an employer of an employee who is a member

of one or more pension funds in any one year of assessment shall be –

- (a) The employer's actual contributions; or
- (b) Up to 15 per cent of the employee's annual salary

whichever is the lesser amount'.

Following the budget statement, commentators have expressed concern that the proposed tax regime will see a decline in employee's savings.⁴⁴

According to Mr Kaferapanjira, the CEO of the Malawi Confederation of Chambers of Commerce and Industry, before the Pension Act pension taxes were calculated based on an employee's gross salary. Thus, under that system if an employee earned K10 000 per month, her 5 per cent contribution to the pension fund would be K500.⁴⁴ Under the proposed system, the employee would be taxed on the K10 000 first. Kaferapanjira hypothesizes that if the taxation rate were 30 per cent, the employee would be left with 70 per cent. This means that the contribution on the K10 000 monthly salary would be based on K7 000 after deducting the 30 per cent taxes from the monthly salary. The employee's 5 per cent pension contribution would now be K350 per month. Had the old tax system been maintained, the employees' pension contribution would have been K500. The point advanced by Kaferapanjira is that since employees are now saving less there will be fewer savings than would have been case had government maintained the old taxation model.⁴⁴

On the other hand, the government will get more taxes now than in the future. If Kaferapanjira is correct in his assertions then employees who belong to defined contribution fund will be the most negatively affected as their benefits are solely dependent on how much they contribute. Those employees will be forced to contribute less every month due to the proposed tax regime. These employee would stand to benefit had the government chose to defer pension taxes until employees exit the fund, which is the approach most countries have adopted. In this way, employees belonging to both types of pension funds would have

benefited, including those employees wishing to save more than the minimum required contributions. For employees belonging to defined benefit funds, the proposed changes in the tax regime may not affect them as much given that their benefits are fixed and somewhat guaranteed by the employer.

There is another point to be made in relation to these proposed tax reforms. As there is already a proliferation of defined contribution funds in Malawi, the likely effect of these tax reforms is that defined contribution funds will not have sufficient money to invest into the economy as less money will be contributed by employees into the pension fund due to the proposed taxation model. Ultimately, this will affect the amounts of benefits that employees will receive at retirement. The overall effect of these proposed tax reforms is that they will remove the incentive to save, and the ability of pension funds to contribute to economic development through their investments. There is also likely to be a ripple effect of these reforms on the economy to the extent that employees will have less money in their hands to spend into the economy.

Moreover, despite the uncertainty around what kind of tax regime will be adopted, it is important to point out that Section 12(4) of the Pension Act, which permits employees to make extra voluntary contributions to the fund, is one area where government can use tax incentives to encourage savings. It is submitted that Section 12(4) is most significant in a defined contribution fund environment because pension contributions paid plus any investment growth are the primary indicators of the pension benefits due to the employee on retirement. There is arguably less demand for an employee to make extra contributions in a defined benefit fund because his benefits are guaranteed. Therefore, it was important for the Pension Act to provide a tax incentive by making all pension contributions tax deductible because this reflected a clear desire by the legislature to promote a savings culture, and without it the primary objectives of the Act are under threat.⁴⁵

Malawi is not the only country that has passed legislation promoting defined contribution funds. In the United States, it is a widely held view among legal academics that the Pension Protection Act robustly enhances defined contribution funds to the extent that defined benefit funds will likely disappear.⁴⁶ Most academics view the Pension Protection Act as a missed opportunity by the United States Congress to revitalize defined benefit funds in the United States.⁴⁶ According to Professor Eriksson, the Pension Protection Act introduces new funding requirements to address inadequate funding problems associated with defined benefit funds. Under these new requirements, most defined benefit funds must be completely funded within 7 years, which is a costly exercise for most employers.⁴⁷

The attempt to address similar underfunding problems is much more stringent in the Pension Act of Malawi, where defined benefit funds are expected to be fully funded within 3 years. Section 87 of the Pension Act provides the following in this regard:

Section 87 (1) Notwithstanding any other provisions in this Act, any pension scheme existing before the commencement of this Act may continue to exist provided that:

- (a) ...
- (b) the pension scheme shall be fully funded and in case of:
 - (i) any defined contribution scheme, contributions in favour of each employee together with the income and asset growth attributable to these contributions but less the corresponding expenses attributable to these contributions shall be computed and credited to a member's account opened for the employee;
 - (ii) any defined benefit scheme, whether or not it is converted in the process to a defined contribution scheme, the value of the assets of the fund shall be allocated to the members in proportion to their respective actuarial liabilities on the same calculation basis as used for the actuarial valuation that is used to confirm that the scheme is fully funded;

- (h) the employer shall undertake to the Registrar that the pension fund shall be fully funded at all times and that any shortfall shall be made up *within 3 years*;

(2) Any employer operating any defined benefit scheme shall undertake, at the end of the first financial year immediately following the date of entry into force of this Act and *every 2 years* thereafter, an actuarial valuation to determine the adequacy of his pension fund assets and shall submit this actuarial valuation to the Registrar for scrutiny, together with a plan of action for restoring the scheme to full funding consistent with the requirements of Subsection (1)(h).

From the above provisions, the Pension Act unlike the Pension Protection Act requires all underfunded pension funds to be fully funded within 3 years. In addition, like the Pension Protection Act, the Pension Act requires pension funds to comply with stringent disclosure requirements including funding status to employees.⁴⁸ Further, Section 87(2) requires employers operating defined benefit funds to produce accurate actuarial fund assessments. Clearly, like the United States Congress, the legislature in Malawi has chosen to promote defined contribution funds by imposing stringent regulation on defined benefit funds, the question that remains to be addressed is whether these reforms are good or bad.

WEIGHING THE BENEFITS OF PROMOTING DEFINED CONTRIBUTION FUND IN MALAWI

In this section, the article examines whether the promotion of defined contribution funds in Malawi should be welcomed. It argues that this development should be welcomed for at least three reasons. First, it is important to keep in mind that before the enactment of the Pension Act the regulation of pension funds in Malawi was left mostly to employers and pension administrators with the government's involvement effectively limited to tax considerations under the Third Schedule to the Taxation Act of 1998.⁴⁹ As a result, employees were left with little protection or recourse if a pension fund

failed to provide a promised benefit. Further, the Taxation Act of 1998 did not effectively address the problems associated with underfunding and other abuses such as failure by employers to make pension contributions.⁵⁰ Most of these funding failures and abuses meant that employees could retire with no pension or little pension that was promised to them,⁵⁰ thereby contributing to the pervasive income insecurity among Malawians.

The problems of underfunding are not unique to Malawi. Generally, defined benefit funds accumulate considerable funding obligations as a consequence of an employee's years of service. Whereas the employee earns the right to benefits in the future, employers do not always fully fund their pension liabilities.⁵¹ However, underfunding is not only caused by failure to fully fund by the employer. In some cases, defined benefit funds can become underfunded because of the decline in value of the pension fund's investments, which sometimes is beyond the employer's control. Professor McClendon illustrates this point through her recent study of the decline in defined benefit funds. In her study, McClendon observed that the decline in the equities markets and long-term interest rates at the start of the last decade resulted in thousands of defined benefit funds becoming underfunded in the United States.⁵² She argues that this phenomenon is equally true in other parts of the world, including Malawi, that were affected by this decline in the equities markets. Conversely, the employer's pension obligations in defined contribution funds are fully discharged once the employer makes the appropriate contribution to the individual pension fund account, and any consecutive events have no impact on the employer's funding obligations in this regard. Professor Pratt has correctly argued that defined contribution funds cannot be underfunded or overfunded because the total value of all member's account is equal to the total value of the fund assets.⁵³ Therefore, the promotion of defined contribution funds could address the funding failures of pension funds in Malawi as these funds are always fully funded and do not require pension insurance for funding protection.

Second, it is generally agreed that defined benefit funds are costly and complex to

administer than defined contribution funds.⁵⁴ This is largely because of the need to engage the services of actuary who determines the funding obligation of the employer. Moreover, defined benefit funds often implement complex benefit structures, which are subject to complex accounting requirements. In Malawi, the complexity is enhanced by the requirements in Sections 87(1)(b)(ii), 87(h), and 87(2) that funds must be fully funded and valuation reports must be submitted every 2 years. These are costly exercises and requirements that have the greatest impact on the financial viability of defined benefit funds.

On the other hand, defined contribution funds are reasonably simple to administer because they operate like a bank account. As a consequence, they are simple to explain to employees and cost-effective to manage and run.⁵⁵ Further, defined contribution funds are said to reflect an employer's desire to limit long-term financial exposure, which is a major concern among many businesses in Malawi in recent years. The cost-effectiveness associated with defined contribution funds, including the fact that employer costs are certain and can be budgeted for, means that there is the potential for these types of funds to make the cost of compliance with the Pension Act more affordable in Malawi.

Lastly, unlike defined benefit funds where the employer's responsibility is to duly contribute and manage the fund (with the ultimate responsibility to pay promised benefits), employees manage and bear the risk of their own retirement savings in defined contribution funds.⁵⁶ In other words, as the employer bears the risks in defined benefit funds, the employer exercises considerable control of the affairs of the fund. On the contrary, due to the assumption of risks by employee in defined contribution funds, employees in these types of funds play a much bigger role in the running of the fund. This role is clearly reflected in Section 26 of the Pension Act, which requires that the Board of Trustees of a fund should consist of equal number of employer and employee representatives. The equal representations rule in Section 26 is a welcomed development in Malawi's pension sector because it will ensure,

among other things, that there is a check on employer's power in matters affecting the fund and possibly prevent previous abuses by employers. For these reasons, the article submits that the promotion of defined contribution funds in Malawi should be welcomed.

CONCLUSION

The enactment of the Pension Act in Malawi should be welcomed because it will promote social and economic development by addressing the problems of income insecurity during retirement and social protection. This article examines the importance of the Pension Act. It focuses its examination on the provisions in the Pension Act that provide for mandatory pension and life insurance. The main argument in this article is that the Pension Act promotes a defined contribution fund because it defines the contributions by every employer and employee; it promotes portability of pension benefits; prescribes the establishment of individual pension accounts; and provides tax incentives to employers and employee. These features in the Pension Act are beneficial to employees and cost-effective to employers.

REFERENCES AND NOTES

- 1 For a series of cases dealing with this double payment of severance and pension by employers, see *Auction Holding LTD v Noel Kabvala & Others*, MSCA Civil Appeal no 48 (2008) (holding that severance benefits under Section 35 of the Employment Act 2000 was mandatory for employers as well as pension benefits for those employers who provided a pension); *The State v. Attorney General ex-parte Mary Khawela and others*, Appeal no 7 (2004)(unreported)(holding that the respondent were entitled to be paid both severance allowance and pension upon termination of their employment); *Chimpeni and Others v. Chibuku Products* Civil Cause no 3225 (2002)(unreported)(agreeing with *The State v. Attorney General ex-parte Mary Khawela and others*); *Stanbic Bank Limited v. Mwaluvanda*, (2007) MWHC 18; *E. K. Thomson vs Leyland DAF (Malawi) Ltd* (2004) MWHC 63; and *International Cooperation Agency vs Verity Jere*, Civil Appeal no 25 (2002)(unreported).
- 2 See Section 35 of the Employment Act 6 of 2000.
- 3 See Section 2 of the Employment Amendment Act 27 of 2010.
- 4 Pension (Salary Threshold and Exemptions) Order 2011, Government Notice 32 of 2011.
- 5 See Section 6(2) of the Pension Act. According to a recent decision by the Registrar, all existing pension schemes are deemed registered under the Pension Act. See *The Nation* (2011), Press Release. 15 August, pp. 36. See also Section 8 of the Taxation (Amendment) Bill no 2 of 2012, which provides that 'any pension fund approved by the Commissioner of Taxes

- shall be deemed to have been registered under the Pension Act'.
- 6 The Registrar was established under Section 8 of the Financial Services Act 2010 with the primary objective to regulate and supervise the financial services industry, which include pension funds.
 - 7 Employment (Amendment) Act 2010, First Schedule, Part II, Paragraph 3. See also Sections 10 and 9 of the Pension Act.
 - 8 Pension (Salary Threshold and Exemptions) Order 2011, Government Notice 32 of 2011.
 - 9 Seasonal worker means employees whose work, because of its nature or because of factors peculiar to the industry in which it is performed, is available, at approximately the same time or times every year, for part or parts of the years. See Section 2 of Pension Order 2011.
 - 10 Tenant means an employee in terms of the Employment Act, who enters the services of a landlord to grow a crop of the landlord or any other related services. See Section 2 of Pension Order 2011.
 - 11 Expatriates means "skilled professionals of foreign origin working in Malawi and holding a valid temporary employment permit issued by the relevant authorities in Malawi". See Section 2 of Pension Order 2011..
 - 12 See Chikopa, L. (2011) Pension Act 2010: Views from the Streets. Paper presented at the Malawi Law Society. Workshop on the Pension Act; 23 September, Blantyre, Malawi.
 - 13 See Muhome, A. (2011) A brief commentary on the provisions of the Pension Act 2011, <http://www.oppapers.com/essays/A-Brief-Commentary-On-The-Provisions/1015617>, accessed 22 September 2012.
 - 14 See Section 86(3) of the Pension Act.
 - 15 This section provides that 'where an employee dies, his entitlement under the life insurance policy maintained under Section 15 shall be paid to the deceased member's account and the trustee shall apply the amount paid in accordance with the requirements of section 71'.
 - 16 For a comprehensive discussion of the death benefit provisions under Sections 70 and 71, see Dyani, N. and Mhango, M. (2012) Pension death benefits under the Malawi Pension Bill no 14 of 2010: Reflections from South Africa and Australia. *Comparative and International Law Journal of Southern Africa* 45(1): 18.
 - 17 Mhango, M. and Thejane, P. (2012) The Malawi Pension Act: A general commentary on some of its core mandatory provisions with specific reference to sections 9, 10 and 15. *South African Law Journal* 12(4): 773.
 - 18 Mhone, G.C.Z. (2003) The social-economic context and social policy needs in South Africa. In: M. Olivier, N. Smit and E.R. Kalula (eds.) *Social Security: A Legal Analysis*. Durban, SA: LexisNexis Butterworths, pp. 1–3.
 - 19 See Pratt, J. (1987) Reversion of Surplus pension assets upon plan termination: Is it consistent with the purpose of ERISA? *Indian Law Journal* 62(3): 805; and Greenough, W. and King, F.P. (1976) *Pension Plans and Public Policy*. New York: Columbia University Press, pp. 27–35.
 - 20 See Borsch, A. (2008) *Pension Trends in Emerging Markets – The Rise of DC Plans and Its Consequences*. Munich, Germany: Allianz Global Investors, Publication no 2, pp. 14–16, (discussing the characteristics of a defined benefit fund). See also Hess, D. (2005) Protecting and politicizing public pension funds assets; Empirical evidence on the effects of governance structures and practices. *U.C. Davis Law Review* 39: 187; and Zelinsky, E. (2004) The defined contribution paradigm. *Yale Law Journal* 114: 457.
 - 21 Zelinsky, E. (2000) The Cash Balance Controversy. *Virginia Tax Review* 19(2): 687–691; Kaplan, A. (2006) *Pension Law*. Toronto: Irwin Law, pp. 2–3 and 99–101; Munell, A. (2006) Employer-sponsored plans: The shift from defined benefit to defined contribution. In: G. Clark et al (eds.) *The Oxford Handbook of Pensions and Retirement Income*. London: Oxford University Press. See also, Borsch²⁰, at pp. 13–116 (discussing the characteristics of a defined benefit fund). See also, Hess²⁰, at, p. 187.
 - 22 See, Borsch²⁰ at pp. 14–16 (discussing the characteristics of a defined benefit fund).
 - 23 Ulrich, K. (2001) You can't take it with you: An examination of employee benefit portability and its relationship to job lock and the new psychological contract. *Hofstra Labor & Employment Law Journal* 19(1): 185.
 - 24 Eriksson, C. (2007) The Pension Protection Act of 2006: Is it too late to save traditional pension plans? *Suffolk University Law Review* 41(1): 141; and Conison, J. (1998) Employee Benefit Plans in a Nutshell, pp. 30–21.
 - 25 Eriksson²⁴ at p. 141.
 - 26 *Kransdorff v Sentrachem Pension Fund and Another* (1999) 9 BPLR 55 (PFA).
 - 27 Forman, J. (1999) Public pensions: Choosing between defined benefit and defined contribution plans. *MSU DCL Law Review* (1): 193.
 - 28 Clarke, R. and Pitts, M. (1999) Faculty choice of a pension plan: Defined benefit versus defined contribution. *Industrial Relations* 38(1): 44.
 - 29 It could be argued that Section 15 of the Pension Act provides a defined benefit component in the Pension Act because it defines and guarantees a fixed benefit in the form of one times the annual pensionable salary of the relevant employee to the dependants or close relations of the deceased employee. This benefit is guaranteed and the employer assumes the entire liability to ensure that the promised benefit is paid when due.
 - 30 See, Kaplan²¹ at p. 20 (discussing the defined contribution fund).
 - 31 See, Peeletso, BPOPF's Newsletter, 6 September 2011, p. 4.
 - 32 id. See also Income Taxation Act 1995.
 - 33 Forman²⁷ at pp. 193–194; Reading, R. (2008) Rethinking 'the Plan': Why ERISA Section 502(A)(2) should allow recovery to individual defined contribution pension plan accounts. *Buffalo Law Review* 56: 315; Jefferson, R. (2000) rethinking the risk of defined contribution plans. *Florida Tax Review* 4: 607; and Rozmus, S. (1994) Insurers beware: General account activities may subject insurance companies to ERISA's fiduciary obligations. *Northwestern University Law Review* 88: 803.
 - 34 Broadbent, J., Palumbo, M. and Woodman, E. (2006) The shift from defined benefit to defined contribution pension plans – implications for asset allocation and risk management: 20. Paper prepared for the working group on Institutional Investors, Global Savings and Asset Allocation established by the Committee on the Global Financial System, Bank for International Settlements, Basel, <http://www.bis.org/publ/wgpapers/cgfs27broadbent3.pdf>, accessed 22 September 2012.
 - 35 Willborn, S. (1998) The problem with pension portability. *Nebraska Law Review* 77(1): 352.
 - 36 id, pp. 362.
 - 37 Borsche²² at pp. 18–20.
 - 38 id at pp. 18–21.
 - 39 Ulrich²³, at p. 185; Munell²¹.
 - 40 Blake, D. (2003) The UK pension system: Key issues. *Pensions: An International Journal* 8(1): 330, Explaining that a typical

UK worker who changed jobs at the average level of six times during their working career would suffer a loss of 25–30 per cent of the full service benefit they would have received had they remained with the same employer throughout their career.

41 See Forman²⁷; Readling²⁷, at p. 322; Jefferson³³ at p. 628.

42 See Income Tax Act 1995, and KPGM (2008) Key Features of Company and Personal Tax in Botswana. Botswana Economic Reform Presentation 2008.

43 Lipenga, K. (2012) 2012/2013 Budget Statement. Speech to Parliament. Lilongwe, 8 June, Paragraph 119.

44 Kandiero, C. (2012) Amended Pension Act to Punish Worker. *Daily Times* 27 June: p. 3.

45 Section 13 of the Pension Act, which provides that tax incentive was deferred from implementation until a further date to be announced to give way for a review of the entire tax legislation. See, Kandodo, K. (2011) 2011/12 Budget Speech. Speech to Parliament. Lilongwe, 3 June. Paragraph 164, <http://www.finance.gov.mw>, accessed 6 June 2011; and General Notice 3 of 2011.

46 Eriksson²⁴ at pp. 148–150–157 (noting that the Pension Protection Act will trigger the decline of defined benefit funds).

47 See Section 501 of the Pension Protection Act. See also Eriksson²⁴ at pp. 147–150.

48 See Sections 58, 59 and 60 of the Pension Act.

49 See discussion by Mhango and Thejane¹⁷ at pp. 776–777.

50 *Mbewe and Others v Shire Bus Lines Limited (In Liquidation)*. (2011) MWIRC 6 (where huge pension arrears were discovered when the employer was being liquidated).

51 Forman²⁷ at p. 194.

52 See McClendon, J. (2007) The death knell of traditional defined benefit plans: Avoiding a race to the 401(k) bottom. *Temple Law Review* 80(3): 823.

53 Pratt, D. (2001) Nor rhyme nor reason: Simplifying defined contribution plans. *Buffalo Law Review* 49(2): 759.

54 Ulrich²³ at p. 185; Forman²⁷ at p. 194; and Stein, N. (2003) An Alphabet Soup Agenda for reform of the Internal Revenue Code and ERISA provisions applicable to qualified deferred compensation plans. *SMU Law Review* 56(1): 627.

55 Pratt⁵³ at p. 761.

56 Eriksson²⁴ at p. 141.