IRISH PENSIONS

Autumn 2016

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Emerging Market Debt: Passive Management on the Rise

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Buy Out Bonds & The ARF Option

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Chairperson's Message

Welcome to the Autumn edition of the IAPF pensions magazine. All of our Committees are back up and running and we have held a number of events over the last 2 months, including our recent Benefits Conference. It was good to hear from the Minister for Social Protection, Leo Varadkar, who was able to take time out of the pre-Budget negotiations to address the large attendance. It was also good to hear him say that the issue of Universal Pensions will be a priority after the Budget process has concluded.

The Pensions Authority Consultation on Pensions Reform & Simplification closed on October 3rd and we made our submission which is available on our website here. We welcome the Consultation and the opportunity to contribute to it. Some of the changes proposed have the possibility to radically alter the make-up of the Irish pensions system, and it is important that they are given careful consideration.

We welcome the acknowledgement of the importance of the role of lay trustees and we have strongly argued that point since the consultation on trustee qualifications last year. They do need support and good trustees recognise that. We aim to support trustees as much as possible to carry out their crucial role. Earlier this year our DC Committee published templates for a DC Risk Register, Trustee Compliance Checklist and Trustee Conflicts of Interest Log. Our Investment Committee has been publishing a series of Investment Topics to help trustees get a better understanding of complex issues in order to help them when they discuss those with their advisers. Our Benefits Committee has published a Wind-up Checklist for DB schemes.

We do believe that there is a need to look at harnessing the benefits of scale within the pensions system and master trusts are a means of doing that. However we also need to ensure that good, engaged employers and trustees are encouraged to set high standards in their own schemes. We need to ensure we don't redesign the system so that it would become too difficult for good schemes to exist.

It was disappointing that the Consultation didn't focus on tax issues or the disclosure requirements. We see both of these as requiring a lot of work if we are to properly simplify the system. We look forward to further engagement with the Authority and the various Government Departments on this.

The other big issue exercising trustees at present is the continuing increase in the value of DB scheme liabilities as a result of historically low interest rates. We have had a significant loss of DB schemes in the last 10 years with the number of active schemes having fallen from just over 1,200 at the end of 2006 to less than 500 today. The number of active members in those schemes has dropped from 270,000 to 126,000 at the end of last year.

The schemes that survived have generally done so because of tough decisions and considerable effort and pain for members and employers. Many employees have seen their benefits reduced, either in payment or what they can expect to receive when they come to retire. Many employers have had to agree to significant increases in their contributions to the scheme. So, despite reducing the schemes' liabilities and increasing assets (DB assets at the end of 2015 were €71.8bn compared to €39.4bn at the end of 2008), schemes are continuing to see the value of those liabilities rising because of the link to interest rates. Interest rates continue to remain low because of the Quantitative Easing policies of Central Banks and it is difficult to see when and how those policies will end.

The schemes that have survived have done so because of the willingness of workers to sacrifice benefits and the goodwill of employers to continue to sponsor the schemes. It would be a real tragedy if they were to be forced to wind up because of the way in which we value the liabilities, rather than focusing on their ability to pay out benefits over the next 30 or 40 years.

We believe it is time to take a wider look at DB funding and the minimum funding standard basis, and this is an issue we will be focusing on over the coming week and months.

Jim Foley
Chairperson

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Emerging Market Debt: Passive Management on the Rise

by Niall O'Leary

Pension investors are well aware that the pool of fixed income assets yielding decent income levels has been greatly diminished and they have been casting around for alternative options. And yet, for one reason or another, many investors seem unconvinced of the merits of an asset class that has developed rapidly in recent years: Emerging Markets Debt (EMD). Investor attitude towards EMD still appears focused on perceptions and assumptions that are too often rooted in the past.

However, a quick scan of developments serves to highlight the advances made in EMD:

- EMD has become a large, diverse and relatively liquid universe.
- The market is now about US$4 trillion[1], with a mix of local and hard currency issues and a well-developed corporate market.
- The increasing breadth and depth of the market has enhanced liquidity.

At the same time, one can understand the reticence to fully embrace EMD. Inefficiencies and volatility remain high and, while those are market factors that active investors traditionally look to exploit, they may actually be too high for active managers to consistently deliver excess returns. We believe that intelligent indexed approaches to EMD that aim to capture this complex market exposure in a consistent and cost effective manner deserve consideration. In fact, such strategies have been gaining market share.

Understanding Why Active Managers Have Struggled

So why isn't the active management approach working in EMD? After all, the perceived inefficiencies and the diverse nature of the market, together with the belief that detailed fundamental knowledge provides an advantage should enable active managers to identify and extract value. But looking at the Morningstar database, we can see that the 30 largest active funds tracking two flagship indices (JPM GBI-EM Global Diversified Index for local currency and JPM EMBI Global Diversified for hard currency) have significantly underperformed their respective benchmarks (Figure 1).

Figure 1: Historical Performance of Active Managers

Percent of Underperforming Active Managers

	1 Year (%)	3 Years (%)	5 Years (%)
Hard Currency Universe	87	97	97
Local Currency Universe	90	93	93

Source: Morningstar as at 30 June 2016. The universe of active managers is generated by selecting the largest 30 live funds with the primary prospectus benchmark of JPM EMBI Global Diversified Index for the hard currency analysis and JPM GBI-EM Global Diversified Index for the local currency analysis.

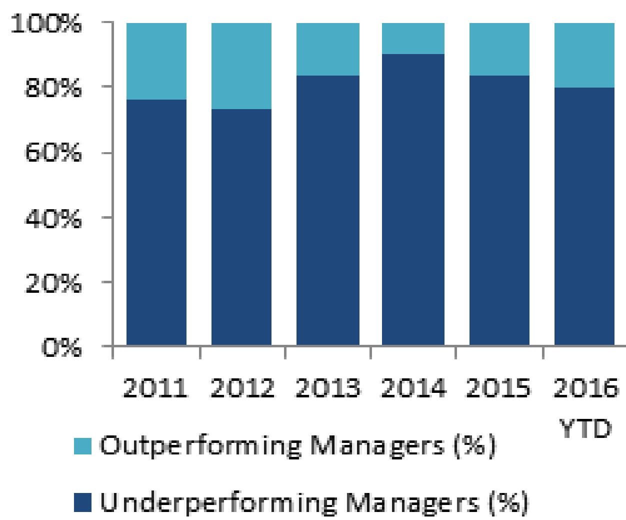
Past performance is not a guarantee of future results.

What is particularly fascinating about this is the fact that underperformance cannot be blamed on a single bad year or a one-off 'Black Swan' event.

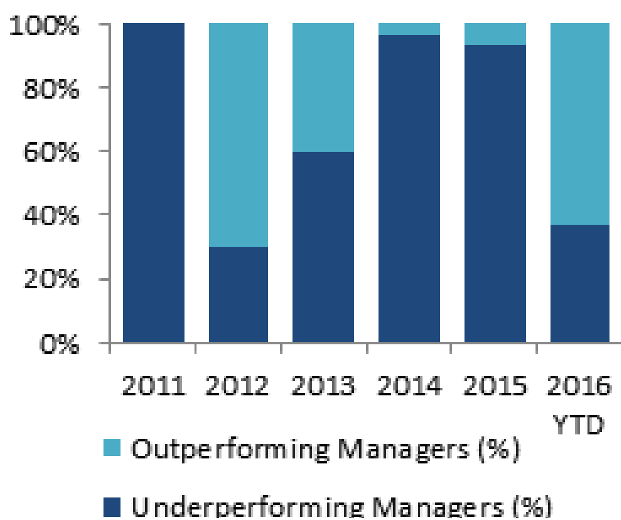
In the local currency segment, the percentage of outperformers is consistently about 20–25%. In the hard currency space, there are some sporadic hits (as in particularly good years like 2012 and H1 2016), but more often there are significant misses that lead to active managers underperforming over the medium and long term.

Figure 2: Active funds' annual performance relative to benchmark

Local Currency EM Debt



Hard Currency EM Debt



Source: Morningstar as at 30 June 2016.
Past performance is not a guarantee of future results.

Ultimately, the inherently 'high-octane' and volatile nature of the EMD sector drives active underperformance. Investor sentiment often drives returns and may be misaligned with fundamental valuations; unpredicatable geopolitical factors also play a part.

Diversification as a Bulwark

Unpredictability could be a byword for EM investing, given that sell-offs are so often event and sentiment driven. But it has been shown again and again that diversification helps mitigate against potential credit events and a credit risk premium can be harvested across the overall portfolio to compensate for such events.

Our study of active managers' biases reveals that the vast majority of funds take a higher beta exposure relative to the underlying market, presumably with the intention of earning carry and benefiting from any market rally. Looking at the hard currency universe, the average beta of active funds stands at around 1.25 – meaning one can expect them to outperform 'up' markets by about 25%. Only 7% of the active fund universe has a beta that is lower than the market, despite the prevailing view earlier in 2016 that emerging markets and China could face a challenging time. In the five-year period to June 2016, funds with a beta of 1 or lower significantly outperformed strategies with higher-than-market betas (average returns of 4.65% vs 2.66%). This is part of the reason why active managers performed so strongly during the hard currency EM bull market of 2012 and the first half of this year. Another reason is likely to be that there were no major individual country 'blow-ups' during those periods.

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Figure 3: Funds beta relative to historical returns

Source: Morningstar data for Hard Currency for three years to 30 June 2016.
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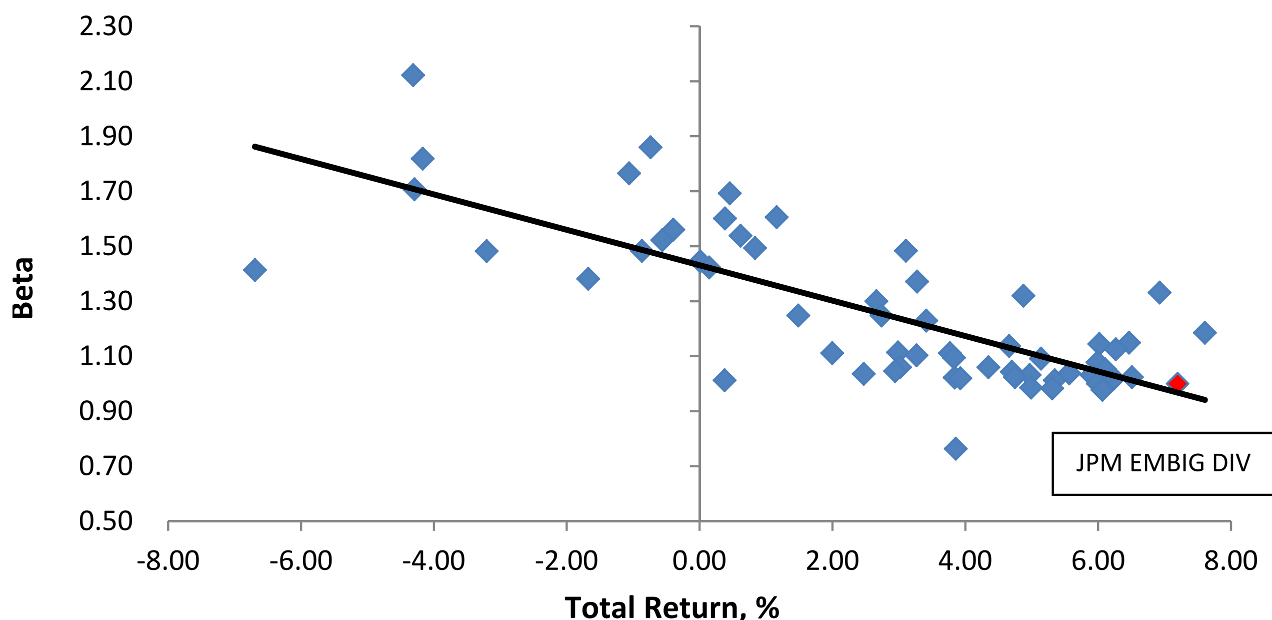

Broad index exposure appears to provide some defence for investors from some of the inherent behavioural biases of active managers and provides higher return potential, even though it means being exposed to both stronger and weaker parts of the market.

Portfolio Construction: Understanding the Underlying Exposure

It is not ground-breaking to state that diversification is considered a positive for investment portfolios. But it is worth looking at how active managers approach portfolio construction. In local currency, active funds have generally invested in more countries than are in the JPM GBI-EM Global Diversified Index. At the same time though, active funds tend to hold significantly fewer securities than the benchmark; at the end of 2015, this index contained 188 bonds across 15 countries, while the average number of holdings in an active fund stood at 89 across 22 countries.

Managing concentrated portfolios in such an idiosyncratic market runs the risk of significantly higher tracking error, while also requiring trading in larger tickets. This may lead to higher trading costs and contribute to the underperformance of active strategies.

Index Strategies Provide Cost-Effective Solutions

So while it is clear that active strategies face headwinds in EMD investing, there were also perceived challenges to adopting index strategies in the EMD space. However, experienced index managers have taken practical steps to minimise the negative effects of historically high replication costs, volatility and considerable inefficiency in the EMD space. At State Street Global Advisors, we have been running indexed EMD strategies for over 10 years and this investment expertise is evident in our consistent and efficient delivery of benchmark returns in indexed EMD strategies and funds.

While the trading cost for EM hard currency bonds is similar to investment grade corporate bonds, the cost of trading local currency denominated securities is half that. The cost of replication is thus no longer as prohibitive as many might think. When you marry this with an experienced, dedicated and co-located EM trading desk, portfolio managers (PMs) are able to keep trading costs down.

EMD indices typically experience higher levels of turnover than other fixed income benchmarks with consequent rebalancing costs. Experienced PMs can minimise turnover by pro-actively anticipating index changes, gaining exposure through primary market placements and working with their traders to access liquidity pools.

While certain taxes are difficult to avoid when holding local EM bonds, a sophisticated investment management process that understands the risk/reward trade-offs between fully replicating the benchmark and alternative positions or proxies can minimise the tax drag without compromising on acceptable levels of risk.

Finally, indexed EMD strategies are not passive when it comes to portfolio construction and security

selection. Experienced portfolio managers consider market dynamics, liquidity and other factors when choosing securities to gain the required underlying exposure in the most effective and performance-enhancing way.

Summary

In times of seemingly ever lower fixed income yields, we consider EMD yields to be relatively attractive. The sector has experienced impressive developments in terms of market size and types of securities available. Active managers have persistently struggled with the volatile and changeable nature of EMD and have largely failed to provide either excess returns or downside protection. More cost efficient and transparent index approaches are now being seen as highly effective and are gaining popularity among institutional investors.

Footnotes
1 Source: Barclays and JP Morgan. As at date 30 June 2016

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IAPF Upcoming Events

Event	Date	Venue
Trustee Refresher Training	18-Oct 2016	ICAI
Trustee Network	26-Oct 2016	ICAI
Trustee Network	9-Nov 2016	ICAI
Breakfast Briefing	16-Nov 2016	ICAI
Trustee Essentials Training	22-Nov 2016	ICAI
Governance Conference	01-Dec 2016	Printworks
Breakfast Briefing	19-Jan 2017	ICAI
Trustee Network	09-Feb 2017	ICAI
Annual Dinner	23-Feb 2017	Double Tree
Investment Conference	23-Mar 2017	Printworks
Breakfast Briefing	06-Apr 2017	ICAI
Iapf Annual Golf Outing	27-Apr 2017	Carton House
DC Conference	11-May 2017	Printworks
Seminar (AGM & Ben Seminar)	25-May2017	ICAI
Breakfast Briefing	08-June2017	ICAI

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IORP II Directive

by Jerry Moriarty

The recently published IORP II Directive which emerged from the EU's Trilogue negotiations on 30 June 2016, will introduce new governance and disclosure requirements for occupational pension plans within the EU. It will also clarify the funding requirements for cross-border schemes and introduce greater member protection on cross-border transfers.

Background

The text for a new Directive on the activities and supervision of IORPs was first proposed by the previous European Commission in March 2014. The final text recently emerged from Trilogue negotiations and although the European Parliament is yet to give its final approval (anticipated in November 2016), this is expected to be a formality. Once it has final approval, Member States will have 2 years to transpose the requirements into national law. The main aspects of the Directive are set out as follows:

Solvency & Funding

The Directive states that IORPs shall have an equitable spread of risks and benefits between generations.

There are no new solvency rules for IORPs in the Directive. In addition, the Directive states that "no quantitative capital requirements such as Solvency II or holistic balance sheet models derived therefrom should be developed at Union level".

Cross Border Schemes

Funding for cross-border schemes: There has been a relaxation in relation to the funding requirements for cross-border schemes. Although schemes are still required to be fully funded at all times, the Directive now states that this condition may not always be met. In such circumstances, the relevant national regulator will be required to intervene and require the IORP to draw up appropriate measures and implement them without delay, in a way that members and beneficiaries are adequately protected. A recovery plan may be put in place where a cross-border scheme is underfunded. This might make cross-border DB schemes a more feasible option.

Cross-border transfers: The Directive contains new requirements that will apply to cross-border transfers. These make it more difficult to transfer IORPs between Member States in search of a more relaxed regulatory environment. Some of the requirements include:

- To obtain the consent of the majority of the members and the majority of the beneficiaries (i.e. pensioners) concerned or the majority of their representatives (which includes trustees)
- To obtain the prior authorisation of the competent authorities in the home Member States of the transferring IORP and the receiving IORP
- For the long-term interests of the members and beneficiaries of the receiving IORP and the transferred part of the plan to be adequately protected during and after the transfer
- Regarding a partial transfer, for the long-term interests of the remaining members and beneficiaries to be adequately protected
- For the receiving IORP to be fully funded at the date of the transfer
- For the assets being transferred to be sufficient and appropriate to cover the liabilities, technical provisions and other obligations or rights to be transferred measured in accordance with the rules in the home Member States of both the transferring and the receiving IORPs

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	Annualised return %	Annualised volatility %	Risk reward ratio
EDGF	5.4	7.0	0.8
Global Equities	6.6	10.5	0.6

Source: Standard Life Investments, as at 31 July 2016. Performance from fund launch 20/11/13 to 13/08/2015 is the Enhanced-Diversification Growth Fund GBP Gross z class, assumed 100% hedged to EUR. Thereafter Enhanced-Diversification Growth pension Fund NBGF gross price series in EUR. Global Equities references MSCI AC World Index – Gross Return (hedged to Euros).

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- For individual entitlements not to be reduced as a result of the transfer.

Governance

IORPs will have to put in place an effective system of governance which includes a transparent organisational structure with a clear allocation of responsibilities.

IORPs will need to have in place and apply written policies in relation to risk management, internal audit and, where relevant, actuarial activities and outsourced activities. Plans will also be required to carry out and document a new own risk assessment at least every three years or without delay following any significant change in the risk profile of the Plan.

The internal audit must be independent from other key functions.

IORPs will have to put an effective internal control system in place which will cover accounting and administrative procedures and appropriate reporting arrangements.

Outsourcing: Schemes will be required to notify their national regulator where they outsource any activities covered by the Directive and prior notification will need to be given before any key functions are outsourced. Schemes will also be required to enter into a written agreement with the service provider where activities covered by the Directive are outsourced.

Fit and Proper Management: IORPs shall ensure that those that run the Plans have the qualifications, knowledge and experience on a collective basis to ensure the prudent management of the IORP.

Remuneration policy: Plans, taking account of the size, complexity and scale of the activities of the IORP, will need to establish and apply a sound remuneration policy for all those persons who effectively run the IORP, perform key functions and other categories of staff whose professional activities have a material impact on the risk profile of the IORP. The policy will also apply to service providers to whom activities are outsourced. It is unclear how the remuneration policy would need to be applied to professional trustees, professional advisers and service providers.

Risk Management:

IORPs shall put in place a risk management structure that is proportionate to their size and complexity of operations and also to the operations which have been outsourced. IORPs will have to produce a risk assessment.

Trustees

Professional qualifications: Each individual trustee will not be required to have professional qualifications as the qualifications, knowledge and experience of the persons who run an IORP can be looked at collectively.

Fit and proper persons: The Directive requires each Member State to ensure that the competent authority is able to assess whether the persons who effectively run an IORP, or have key functions, fulfil certain fit and proper person requirements. If implemented, this could mean that the Pensions Authority would need to have greater involvement in assessing and monitoring the fitness and propriety of pension plan trustees.

Communications

Members must be given information on the past performance of the scheme for the preceding 5 years when joining a scheme where they bear the investment risk.

Annual accounts and reports should be publicly disclosed.

Pension Benefit Statement

Statements may be issued in electronic format and be should be presented in a way that is easy to read. The statement should include a best estimate and an unfavourable scenario. Deferred members will be required to receive a statement.

ESG factors

There are multiple references in the Directive to those running an IORP being required to consider environmental, social and governance factors in investment decision making.

Supervision

Supervision should be forward looking and risk-based. It should be applied in a manner that is timely and proportionate to the size and complexity of the IORP.

The Regulator will have the power to seek documentation regarding governance, risk management and other issues.

Next Steps

The Department of Social Protection will be responsible for putting the legislation in place to transpose the requirements of the Directive into Irish law by November 2018. There are a number of key decisions that will need to be made. Firstly, smaller schemes (generally less than 100 members) can be exempted from most of the requirements of the Directive. Secondly many of the new requirements shall be “proportionate to the nature, scale and complexity of the IORP” which gives some scope on the interpretation of the next steps. The IAPF Benefits Committee will be looking at the detail of the Directive and its potential impact on Irish schemes.

Article Author

Jerry Moriarty
CEO
IAPF

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Buy Out Bonds & The ARF Option

by Carmel Devine

22nd June 2016 was a very important day for deferred members of defined benefit schemes and individuals who had already moved those benefits to Buy Out Bonds. The Minister for Finance confirmed that he had arranged for individuals who have a Buy Out Bond that originated in a defined benefit pension scheme to be allowed to use their Buy Out Bonds to access the ARF option.

Impact of the change:

- Those who have already taken a transfer value from a DB scheme to a BOB now have both the traditional benefit option and the ARF option on accessing a BOB
- Deferred members who decide or are forced (through scheme wind-up) to take a transfer value from a DB scheme can access the ARF option by a transfer to a BOB as well as retaining the traditional benefit option

Is BOB now the transfer product of choice?

All deferred members of DB schemes taking a transfer value have the option to transfer to a BOB but some may also have the option to transfer to a PRSA or to a new DC scheme of which they are a member.

However, a transfer to a BOB now looks like the most flexible option for most clients with deferred pensions in DB schemes who have decided to take a transfer because:

- No Certificate of Benefit Comparison will be required for the transfer as applies to PRSAs where the transfer value is greater than €10,000
- The BOB will provide both the ARF and traditional access option
- The BOB will provide earlier (from 50 onwards) access to benefits even if working in a new employment/self-employed

Opportunity

While the extension of the ARF option to BOBs funded by a transfer value from a DB scheme is welcome, the decision to voluntarily take a transfer value from a DB scheme in lieu of retaining a deferred pension in the scheme should not be made solely on the basis of an ability to get the ARF option. There are many other "value for money" and risk issues to be considered in making such a decision. The traditional benefit option may still be the best options for some clients, but at least all BOB clients will now have the choice of ARF and traditional benefit options and that is a very important change.

Investment choices

In recent years there have been some really significant

developments in the industry that make investment funds even more compelling and customer friendly. The launch of several absolute return funds in the Irish retail market has to be welcomed, as the objectives of the customer and the fund manager are absolutely aligned – both seeking positive returns in all market conditions.

The second significant development has been the introduction of risk based multi asset funds. With risk based funds the clients' investment goals are more aligned to their risk appetite. Unlike the days when many customers were sold managed funds, today advisers have access to portfolio management and risk tools, giving greater choices that allow for more personalised customers solutions, and also help advisers strengthen their investment process.

Standard Life has been to the forefront of these developments with the introduction of absolute return funds (GARS) and the MyFolio range of risk based funds. This year, we launched the Enhanced-Diversification Growth Fund (EDGF) to the Irish market. It combines our two principal strengths in multi-asset investing. It utilises dynamic management of traditional market investments, our core focus for decades, and our recognised skills in absolute-return investing. EDGF targets an equity-like return over a market cycle (typically 5-7 years) with just two-thirds of equity-market volatility.

Standard Life continues to lead the way in Ireland when it comes to investment innovation. EDGF is another great example of such innovation – and it's now available to members of corporate pension schemes (both DB and DC), as well as a fund choice on the Synergy range of pension and investment products.

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Preserving market gains a key challenge for Trustees

by Kevin Barrett

Irish pension funds have been making a strong recovery in value in recent years. This is clearly demonstrated by the yield from the Stamp Duty levy on pension assets, introduced in 2011. In the first year in which the levy applied €77.1 billion in pension assets were subject to the tax. In 2014 this was just under €100 billion and by the time the final instalment of the levy was due in June 2015, Irish pension schemes had staged a remarkable increase in size to €112.6 billion. This was some 46 percent higher than four years previously, reflecting strong market returns as well as employer contributions.

In the last twelve months, both equity and bond markets have continued to move up strongly. In particular bond funds, both government and corporate, have enjoyed the benefits of Central Banks easing monetary policy. This has significantly underpinned returns with global bond funds up 10% year to date. Equity markets are delivering steady, if unspectacular gains, with emerging markets, pacific basin and North American regions outperforming Europe. The total value of Irish pension schemes is now likely to be in the region of €120 billion.

Many myths have grown up about pension schemes over time, aided in some cases by dramatic newspapers headlines. Falling stock markets make for good stories but precious little attention has been given to the improvement in the valuation of pension schemes in recent times. We regularly hear about pension schemes being “wiped out” and defined benefit schemes being “a thing of the past”. The reality is very different.

In fact, Irish pension schemes have taken action to address deficits, implementing of detailed funding plans. While a significant number of smaller defined benefit pension schemes have closed the pace of closure has slowed. Contrary to a widely held perception, Defined Benefit schemes are and will continue to be central to the Irish pension landscape for many decades to come.

The recently published Pension Authority Annual Report sets this out in clear detail. At the end of March this year there were 133,000 active members of defined benefit schemes subject to the funding standard, a marginal reduction on the 135,000 members a year previously. In addition there are over 100,000 current pensioners in defined benefit schemes and 413,000 deferred members.

For many of these deferred members their DB pension will be the bedrock of provision for their retirement. Add in the nearly 340,000 active members of public sector defined benefit schemes and you have over one million people for whom a DB pension is central to their long term financial wellbeing.

A key challenge for pension fund trustees is how to protect the hard won gains in the value of schemes for

which they are responsible. Equities provide a valuable growth element for schemes and since markets began their recovery in March 2009 they have been on a strong upward path with some markets reaching all time record highs in recent months.

On a valuation basis global equities are currently above their long term average. A benign economic outlook should support modest growth in earnings in the year ahead. However the current consensus for global earnings growth in 2017 of 13% appears ambitious when considered in the context of economic growth of around 2.5%. Typically this would be associated with mid-single digit growth in earnings and share prices. There is a real risk that downgrades to earnings and disappointing earnings outcomes will be a regular feature in 2017.

Against this backdrop trustees looking at their asset allocations may be tempted to bank some of their equity gains and seek lower risk options. However, negative yields and concerns about rate rises make bonds less attractive at current levels.

One option is for investors to consider low volatility stocks as a distinct asset class. Financial theory suggests that investors should expect higher returns for taking greater risk but research has shown that low volatility stocks have delivered superior returns compared to high volatility stocks. This low volatility anomaly is seen to be exhibited across times and regions.

Irish Life has developed a Global Low Volatility Active Equity Fund which is designed to allow investors to benefit from this market anomaly, delivering superior returns while providing downside protection over a full market cycle by selecting equity securities, based on a diverse range of factors, compared to traditional capitalisation weighted equity benchmarks.

The strategy gives investors the opportunity to remain fully exposed to the equity risk premium while aiming to deliver lower volatility and reduced drawdowns during market crashes. These severe market events are occurring with increasing frequency. On average global markets have fallen by 20 percent over 2 –3 years and by 30 percent every 9 years.

The Global Low Volatility Active Equity Fund aims to minimise drawdown experience by reducing the extent of losses, the period over which losses are incurred and the frequency of losses. We apply a multi-factor model which considers valuation, earnings and price risk metrics along with sector allocation to provide complementary protection. It has been back tested in multiple markets scenarios and been demonstrated to deliver lower volatility, significant reduction in drawdowns higher annualised returns while maintaining participation in market upside.

While the Fund will tend to be overweight defensive sectors such as utilities, the screening process eliminates stocks which are overpriced on a valuation basis. The overall strategy targets broad diversification across sectors and actively limits sector concentration.

Pension trustees will continue to have to grabble with many issues in the years. Strong asset growth has helped their funding position but brings challenges in its own right. Seven years of strong equity market returns provide an opportunity to explore new approaches which maintain exposure to upside potential but minimise the impact from market falls. Low Volatility investing is a strategy that may provide trustees with a timely outlet for risk reduction while preserving the opportunity for future growth.

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Irish Life Investment Managers

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Employment Law Update - How does an Employer Objectively Justify a Mandatory Retirement Age?

by Elizabeth Ryan

Employers can establish a mandatory retirement age for employees but such ages must be capable of being reasonably and objectively justified if they are challenged by employees as being discriminatory on grounds of age. We review criteria considered in case law which employers can rely on to demonstrate that the setting of a retirement age is objectively justified.

Employers often question what constitutes objective justification of a retirement age as there is no clear statutory guidance on this point. Instead, many of the objective justification 'tests' have been set out in case law both from the Irish court and the Court of Justice of the European Union.

Ideally, in advance of setting a mandatory retirement age, or reviewing a mandatory retirement age already in place, employers should consider the criteria for objective justification considered in recent case law, with a view to determining if it is capable of being objectively justified.

1) Health and safety concerns

Courts have found it justifiable to have mandatory retirement ages for employees who work as drivers, pilots and in jobs which are physically demanding. However not every working environment carries with it the same risks to health and safety. Therefore an employer would need to be in a position to demonstrate by way of a hazard identification and risk analysis exercise that they have evaluated their particular work environment in setting a mandatory retirement age, rather than simply following a historically established retirement age. This is particularly relevant in places of work where technological innovations might have resulted in work becoming less physically demanding.

2) Succession planning

Employers need to plan for the future in order to ensure that they have the right people in place with the requisite skill sets and experience to support the activity of the organisation at a future point in time. Mandatory retirement ages have been held to promote this aim by facilitating the retirement of older employees which opens up opportunities for younger employees who may have differing skill sets and experience.

3) Establishing an age balance in the work-force

Mandatory retirement ages when used to establish a balanced level of experience in an organisation has been found by courts to be objectively justified because it provides an organisation with a wider mix of skill and

experience and allows for the recruitment of people with newer and differing skill sets and experience.

4) Encourage the recruitment and promotion of younger people

Courts have accepted arguments from employers that a mandatory retirement age was necessary to encourage employees to stay with, and progress within an organisation and to motivate employees by the prospect of being promoted into more senior roles.

Terminating the employment contracts of employees who have reached retirement age makes it easier for other workers to find work. This justification can be supported by national employment policies such as stimulating the labour market, reducing unemployment and vocational training objectives.

Conclusion

Employers should note that in determining if a mandatory retirement age is discriminatory on the age ground that Courts approach each matter on a case-by-case basis. Courts look to the requirements and circumstances of each organisation when determining if a mandatory retirement age constitutes age discrimination. Therefore, employers should be able to demonstrate that they considered their individual mandatory retirement age carefully, taking into account the particular requirements of their own organisation and the roles carried out by their employees in order to objectively justify a mandatory retirement age.

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The ARF option and mixed DB & DC benefits

by Tony Gilhawley

Members of frozen DB schemes who are also members of a DC scheme related to the same employment will take retirement benefits from two schemes, either when they retire from that employment or as a deferred member having previously left that employment.

A Revenue Practice requirement seeks to deny the ARF option under the DC scheme to such retirees, or at least to restrict their DC scheme lump sum entitlement. But this flies in the face of legislation as Revenue have not in fact any discretionary powers to impose such restrictions on the ARF option under a DC scheme.

Entitlement to the ARF option

When the ARF option was introduced in Finance Act 1999 it was implemented into legislation in such a way as to NOT be subject to normal Revenue discretionary powers applicable to exempt approved retirement benefit schemes. And this approach has been followed in various amendments and extensions of the ARF option since then. The current legislative position in relation to DC schemes and the ARF option is:

- A DC scheme established on or after 6tH February 2011 can NOT be approved by Revenue unless it contains the full unconstrained ARF option as set out in s772(3A)(a) Taxes Consolidation Act 1997. Basically a scheme approved on or after 6tH February 2011 **MUST** offer the full ARF option as set out in s772(3A)(a) Taxes Consolidation Act 1997 as part of its rules.
- Revenue can NOT use the discretionary power (set out in s772(4)(a) TCA 1997) to deny the ARF option to any DC scheme established on or after 6th February 2011. See s772(4)(c) TCA 1997 which was inserted into legislation when the ARF option was originally introduced in 1999. It is therefore the clear intent of the Dail that deciding who is and who isn't entitled to the ARF option (and the terms of the ARF option) would be a power held by the Dail and not by Revenue.
- DC scheme established before 6tH February 2011 are entitled to change their rules, without requiring Revenue consent or approval, to offer the full ARF option as set out in s772(3A)(a) Taxes Consolidation Act 1997. See S19(7)(f) Finance Act 2011 (No 1).

The combination of the above is that all DC schemes established on or after 6th February 2011 MUST offer the full ARF option to scheme members when taking retirement benefits, regardless of whether the member has or has not separate DB benefits related to the same employment. And DC schemes established before that date can offer the full ARF option to all scheme

members, regardless of whether the member has or has not separate DB benefits related to the same employment, as if scheme was established on or after 6tH February 2011.

Revenue practice intervention

Revenue introduced (at some stage on or before February 2006) a restriction on 5% directors in relation to how they can take their retirement benefits as between the traditional benefit and the ARF options:

Where a 5% director exercises an option, he/she is treated as having exercised the same option in relation to all schemes from the same employment. An option may only be exercised if the individual is a 5% director of the company that established the scheme and if all benefits from the same employment are treated in the same way. [1]

The position above continues but was supplemented by an additional provision in the June 2013 Revenue Pensions Practice Manual (following the extension of the ARF option to all DC schemes from 6th February 2011):

"Members of multiple occupational pension schemes must exercise the same option in respect of each scheme. However, as noted above, an individual may

make a different option in relation to AVC funds than that made in respect of their main occupational pension scheme benefits." [2]

This additional provision is wider in scope (applies to all scheme members and not just 5% directors) and to all schemes (whether related to the same employment or not) than the previous provision which related only to 5% directors and scheme benefits from the same employment.

The provision was clarified in the July 2014 Manual as applying only to benefits from multiple schemes related to the same employment (which may well have been the original intention):

"*Members of multiple occupational pension schemes relating to the same employment must exercise the same option in respect of each scheme. However, as noted above, an individual may exercise a different option in relation to AVC funds than that made in respect of their main occupational pension scheme benefits.*"

A revised August 2016 Chapter 23, issued by Revenue, contains the same provision as above.

In simple terms, the Revenue Practice requirement attempts to deny the ARF option in a DC scheme where the individual also takes benefits from a separate DB scheme related to the same employment, as the DB benefits must be taken under the traditional benefit option (unless the member is a proprietary director). However as outlined above, my view is that Revenue have no powers to deny the ARF option to such DC retirees with separate DB benefits; the power to decide who is and isn't entitled to the ARF option is reserved to the Dail.

April 2014 'concession'

Industry representations on the issue of mixed DB and DC benefits from the same employment triggered an apparent 'concession' from Revenue which is clarified in a letter of 27th March 2014 to the IAPF.

The 'concession' is that in the specific circumstances of closed frozen DB accrual and future DC approval in the same employment, the ARF option can be provided in relation to the DC benefits (non AVCs) subject to restrictions on the maximum lump sum and pension combinations between the two schemes.

Further clarification was promised in the 2014 Pensions Practice Manual, but when the updated Manual appeared it did not contain any such clarification and therefore continues to contain the existing the provision outlined above.

The letter suggests that only in the circumstances of a closed DB scheme where future accrual is made by way of a separate DC scheme that:

- If no lump sum is taken from the DB scheme, 25% of the DC fund can be taken as a lump sum under the ARF option; however, in this case the maximum approvable pension which can be provided by the DB scheme is reduced by the DC lump sum taken divided by 9.
- If the maximum allowed lump sum (under the traditional benefit option) is taken under the DB scheme, e.g. by commutation of pension, then no lump sum can be taken from the DC scheme under the ARF option; the entire DC scheme fund can be transferred to an ARF;
- If a lump sum taken from the DB scheme is less than the maximum allowed lump sum (under the traditional benefit option), then a further lump sum can be taken from the DC fund (under the ARF option), to bring the total lump sum provided to the maximum allowed lump sum under the DB scheme. The maximum approvable pension which can be provided by the DB scheme is reduced by the DC lump sum taken divided by 9.

In effect Revenue are attempting by use of Revenue Practice to restrict or in some cases deny entirely the 25% lump sum option under the ARF option in the DC scheme. However as outlined above, my view is that Revenue have no powers to restrict or deny the 25% lump sum option under the ARF option in the DC scheme as the ARF option must mirror that of s772(3A)(a) TCA 1997, which taken with s772(3B)(b) TCA 1997, provides an unfettered right to take a 25% lump sum as part of the ARF option.

DC scheme trustees

Trustees of DC schemes should look to their own rules first and examine their ARF option as approved by Revenue (where the scheme was established on or after 6th February 2011) or the ARF option inserted into the scheme rules where the scheme was approved before 6th February 2011.

The ARF option should be the full unrestricted ARF option as set out in s772(3A)(a) TCA 1997. In that event, DC scheme trustees should take legal advices before attempting (on foot of a Revenue practice intervention which has no legal underpinning) to either deny a member the ARF option under the DC scheme or to restrict or deny the 25% ARF lump sum option, even if the member has separate DB benefits.

1 February 2006 Revenue Practice Manual

2 Chapter 23.2, Revenue Practice Manual, June 2013

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Venture Capital will enhance Pension Fund Returns

In a period of low interest rates, high alpha returns from an investment in venture capital can have a significant impact on pension fund returns.

by Regina Breheny

Venture Capital:

- Invests in ground breaking innovation always seeking the disruptive technology;
- Builds fast growing businesses, only financing the most promising start-ups;
- Generates relatively high returns. Irish Funds are currently producing top quartile returns of 20%+ IRR;
- The investment outlook is very positive driven by maturing technology sectors, experienced globally focused entrepreneurial teams and low entry valuations;
- Exit valuations are driving top returns;
- Funds are fixed term, self-liquidating, regulated limited partnerships.

Over the last 15 years, the venture capital industry has grown and matured substantially to become an established part of many institutional investors' portfolios, with pension funds among some of the most active investors in this type of asset class. Invest Europe's (EVCA) data shows that almost a third of the capital raised by European venture capital funds in recent years came from pension funds. In the UK private equity continues to outperform other asset classes over the long term and in recent years venture returns are also outperforming significantly. Existing investors are looking to increase their exposure, with a third of pension fund respondents to a Greenwich Associates report expecting to up their allocations over the next few years.

What is Venture Capital and how can a pension fund access this asset class? Irish Funds are currently producing top quartile returns of 20%+ IRR. The investment outlook is very positive driven by maturing technology sectors, experienced globally focused entrepreneurial teams and low entry valuations. Exit valuations are driving top returns.

Venture capital provides equity and hands-on support to companies, often in a series of "rounds" or tranches of funding as pre-agreed milestones are met. Venture capital is ideal for SMEs at start-up, growth and expansion stages of development that are unsuited for debt at this stage of their development because their underlying assets are typically based on intellectual property.

In essence venture capitalists:

- invest in ground breaking innovation, fostering the commercialisation of ideas into new products and processes while always seeking the disruptive technology;
- build fast growing businesses, only financing

the most promising start-ups that could have a multiplier effect on wealth creation and on higher living standards;
- generate relatively high returns by accessing the superior growth rates of these smaller, unquoted, immature, developing companies.
- A venture capital firm establishes a Fund that has the following characteristics:
- The Fund is normally structured as a Limited Partnership with a fixed 10-year life. Capital is provided by long-term private and public investment funds e.g. Pension Funds, Life Insurance

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Lifestyling
Factor Investing
factor
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companies, Endowment Funds, Foundations, Sovereign Wealth Funds and State bodies. Venture capital fund managers also co-invest with other investors;

- The capital is only drawn down as the Fund makes its investments, venture capital funds don't hold cash;
- The investment period for the Fund is generally five years, and after that the focus is on managing and making follow-on investments in an existing portfolio. After an initial investment is made in a portfolio company additional capital is reserved to fund further development but is only drawn down from investors as it is required;
- investors and eventually the Fund is closed. In effect the Fund is self-liquidating;
- After the five-year investment period the venture capital firm raises capital for a new Fund;
- The venture capital firm itself is regulated by the Central Bank of Ireland under the AIFM (Alternative Investment Fund Manager) Directive and can elect to register its fund under the EuVECA regime. This is a voluntary regime that provides venture capital funds with the benefits of a single EU-wide marketing passport yet with lighter-touch regulatory requirements than those mandated by the AIFMD.

Venture capital teams usually have a technology background (scientists, engineers, researchers) or a business background with deep industry experience. A core skill is the ability to identify novel technologies that have the potential to generate high commercial returns at an early stage. Normally the interests of the venture capital fund and entrepreneurs are aligned and both have a common interest in building a business and exiting it through an IPO or a trade sale over time.

Irish firms have specialist domain knowledge and invest primarily in fast growing high tech companies operating in the ICT and the Life Sciences sectors. These companies are developing deep technologies, addressing global markets and creating thousands of high calibre jobs. Irish venture capitalists add significant value to portfolio companies by syndicating with tier 1 international Funds and corporate investors, by introducing international business partners, customers and acquirers, by recruiting senior management, by introducing corporate governance and by endorsing the business and management team to the sector in which it operates.

Why should a pension fund invest in this asset class?

An investment in a venture capital fund provides:

- **Performance** – The most powerful rationale for pension funds to invest in venture capital is its ability to provide good returns on an absolute and relative basis. In the UK, BVCA figures show that pooled venture fund IRRs exceeded the FTSE All-Share returns over 1, 3 and 5 years at an accelerating rate. Irish Funds are currently producing top quartile returns of 20%+ IRR. The investment outlook is very positive driven by maturing technology sectors, experienced globally focused entrepreneurial teams and low entry valuations. Exit valuations are driving top returns.
- **Diversification** - In an uncertain world, venture capital is an increasingly attractive volatility flattener because it is imperfectly correlated with public markets and so it can have a smoothing effect on the volatility of the pension scheme that is inherent in investing in public equities and other risk assets. It offers attractive risk returns, with control, plus long-term out-performance and a non-cyclical approach.
- **Access to High Growth** – Venture capital funds offer investors access to private companies that are operating in specialised sectors in high growth markets that are otherwise hard to gain exposure to via other asset classes. The companies are often smaller, fast-growing businesses that are operating under the radar of other types of fund manager.
- Long-term Horizons – Pension funds need assets that generate long-term returns above inflation so that they can meet their liabilities. The long-term nature of venture capital investment provides a good match for the long-term liability profile of a pension fund. With returns generated over a ten-year stretch (sometimes longer) exposure to venture capital can help pension funds with liability matching alongside more liquid investments, while also providing a premium for illiquidity.

Irish VC managers, with over €1bn of AUM, invest primarily in companies located in Ireland, the UK, Europe and the US. They are managing larger funds with proven teams that have domain expertise with access to global networks.

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What are the risks and how are they managed?

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versed in dealing with asset risk. However, as part of the portfolio control and management process, it is important to identify the risks associated specifically with venture capital:

- **Illiquidity and Irregular Cash Flows** - Investing in venture capital requires investors to invest a pre-agreed amount of capital (or commitment) over the fund's life. It takes time for investments to be sourced, businesses to be built and exits to be achieved. This makes it an illiquid investment that requires capital to be tied up for a long period of time. However, investors do not need to provide the entire amount of capital committed up front. Instead, capital is drawn down as fund managers make investments and limited partners need to ensure they have sufficient liquidity to meet drawdown requests. Investors should also expect low or negative returns in the early years of a fund's life because of the time required to source and make investments. In addition, the fund's establishment costs, management fees and running expenses need to be covered. Returns start to be generated and distributed in the later stages of the fund life as portfolio companies mature and exits occur. When plotted against time to show limited partner's (LPs') net cash flows, this pattern of drawdowns and distributions normally results in a J-curve effect. As distributions usually start before the whole commitment has been drawn, it is unusual for an LP ever to have the full amount of its commitment under investment by the manager. In practice, the peak outlay by investors generally amounts to not more than about 65% of the funds committed and net cash flows turn positive from about the fifth year with payback of monies committed achieved by year 8. Strategies to mitigate or accelerate the J-curve effect include investing the capital not yet requested (or uncalled capital) in easily accessible money market instruments, or over-commitment i.e., committing more capital to a fund in the expectation that distributions will start to flow before the full committed amount is due.
- **Manager Selection** - Choosing high-quality fund managers is one of the most important factors in the success of a venture capital programme. The hands-on nature of the asset class means that the extent of the skills and experience of the fund manager can make a substantial difference to the returns generated. There can be a high dispersion or difference between the top and bottom quartile funds by performance. Many studies have suggested that there is a persistence of returns. However this persistence can be weakened in extreme circumstances like the recent financial crisis when fund managers had to adapt to a new investment and economic environment. This underscores the importance of investors conducting thorough due diligence on fund managers before committing capital. This should examine not just past fund performance numbers, but also dig deeper into individuals' track records and experience as well as looking at how a firm has generated its returns in the past and how it intends to do so in the future.
- **Control over Investment Choices** – LPs, as passive investors, delegate responsibility for deal sourcing, investing, managing portfolios and exiting investments to the venture capital fund manager. As such, they do not exercise any control over individual investments made and make a commitment to a blind pool (i.e. they do not know at the outset which specific investments will be made over the life of the fund).

  However, the investment strategy to be employed by the fund manager is pre-agreed at the point of fundraising and is set out in the limited partnership agreement (LPA), which offers investors in the fund protection against off-strategy investments. In addition, the LPA should also include limits on the amount (usually as a percentage of the fund total) that can be invested in each portfolio company to avoid concentration risk.
- **Company Risk** - Fund managers undertake rigorous due diligence before investing to ensure they understand the risks each portfolio company faces and to identify areas for improvement and growth. This helps mitigate the risk of loss of capital, although it does not completely remove it and there remains a risk that a portfolio company does not perform to plan. However, the active involvement of fund managers post-investment, including taking board seats, should lower the risk of this happening. In addition, the portfolio approach taken by venture capital fund managers helps to diversify risk across a number of investments.

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Eamon Thornton and Peter Young - LEO Pharma receiving PQS with merit award from Jerry Moriarty - CEO, IAPF

Richard Kelly, Greg O’Sullivan and Richard Dignam - daa receiving PQS award from Jerry Moriarty - CEO, IAPF

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