



IAPF Green Paper Response

A report prepared by the Irish Association of Pension Funds in response to the Government Green Paper on Pensions

May 2008

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Appendix 1: An Analysis of certain Tax aspects of the Irish System of Pension Provision. Research Report by Life Strategies (May 2008).

Appendix 2: Defined Contribution Member Options – Annuities and Approved Retirement Funds. IAPF Paper (November 2007).

Appendix 3: IAPF Services Sector Survey (July 2007).

Appendix 4: The Advantages of a State Backed Annuity Purchase Scheme in the Context of the Current Funding Standard. IAPF Discussion Document (May 2005).

Introduction

The Irish Association of Pension Funds (IAPF) is the representative body for Irish occupational pension schemes and for those responsible for their operation. Our members provide retirement security to over 200,000 employees, pay pensions to nearly 70,000 people who have already retired and are responsible for some €87 billion in retirement savings.

We welcome the Green Paper, the opportunity to contribute to the process and the opportunity to inform the decisions that need to be taken to ensure we can continue and build on the strong pension system we have in place in Ireland. It is clear from the Green Paper and the experiences of our members that there are many difficulties to be faced and our response outlines how we believe these can be best tackled.

We believe that the Irish pension system is well developed and operates on a very sound model. The State pension is designed to ensure the continuation of fundamental living standards in retirement. In addition, we have a strong and well regulated system which allows employers and pension providers to deliver robust arrangements (individual & group; contract & trust based) in order that individuals can plan for their own retirement. The State provides incentives that encourage participation in pension savings by exempting contributions and investment returns from tax but recoups some of those incentives by taxing retirement income.

On a global basis the cost of pension provision, both State and private sector, is rising at a significant rate and demographic changes such as improved longevity and lower active and retired population ratios are accentuating this costly experience. Furthermore, not enough people are saving for their retirement while many more are not saving sufficiently to provide the income they will need or would like to have in retirement. We believe that there is a strong framework in place through the mandatory Social Welfare and the voluntary supplementary systems. Individuals need to be encouraged to take out supplementary pensions and there is considerable scope to improve participation, coverage and adequacy levels by making our current system more transparent and more attractive.

Research commissioned by the IAPF identifies a number of barriers which discourage individuals from saving towards their retirement. Many of these barriers can be removed quite simply and we believe that addressing these issues will result in significantly improved levels of pensions coverage and adequacy. We believe that any form of mandatory provision, on top of the already mandatory State pension, will undermine current provision. This has happened in other countries where mandatory provision has set a contribution benchmark lower than pre-existing levels. We believe it is better to increase the numbers of people with good provision while ensuring that State benefits deliver a basic standard of living to all.

Individuals need to recognize that the primary responsibility for ensuring that they have adequate provision in retirement rests with them. Employers, the State and the pensions industry provide much support but it is up to individuals to prepare for a crucial part of their lives and well-being.

We believe that all solutions should be sustainable, adequate, fair and equitable, simple and flexible. On occasion these may conflict but we believe that these core values are contained throughout our response.

Patrick Burke
Chairman

Summary

Chapter 6 – The Social Welfare Pension: Reform Options

We support an adequate Social Welfare Pension that achieves its purpose of providing for a basic standard of living in retirement. It should be flexible enough to cater for groups such as homemakers, carers and new and returning immigrants in a fair manner.

The costs of the Social Welfare Pension need to be considered on a long term basis as well on on a “next year” cost basis. Any promises or decisions made now in relation to the level of Social Welfare Pension impact significantly over the next 30 to 40 years. There is merit in considering further advance funding of these future costs through the National Pensions Reserve Fund or some other funding mechanism.

There is merit in developing, on an ongoing basis, a governance framework and non-political or cross-party infrastructure for the purposes of dealing with the future costs of any improvements proposed for the State pension in order to ensure that the sustainability of the Social Welfare pension is not threatened by political decisions designed to garner electoral support at any point in time.

Chapter 7: Supplementary Pensions – Incentives for Retirement Saving

IAPF has commissioned independent research, carried out by Life Strategies, on the costs and benefits of tax incentives and allowances within public and private sector pensions in order to improve the quality of public debate on how improvements to the State pension might be achieved.

Simplistic modelling of historic data and current cost accounting has failed to provide policy makers with a clear view of the economic consequences of the various public policy options which might exist to enhance the State pension as our population ages.

Those who have suggested that the “cost” of tax relief could be diverted to the State Pension greatly threaten the sustainability of the State pension over the long term.

The report (attached as Appendix 1) quantifies the risk of comparing the relativities of proposed State Pension enhancements and the costs of tax incentivisation on a current cost basis while the projected future costs associated with such enhancements are unsustainable. In addition, the report establishes that the current cost of incentivisation is not directly transferable to the funding of first pillar pensions.

The report also confirms that the design of the current deferred taxation system does not favour high earners over those on lower incomes. In point of fact, the net effective rate of tax relief is significantly lower for higher earners while the greatest beneficiaries of the current taxation system are those in the public sector and those in low to medium pay grades (circa €40,000 p.a.) of the private sector.

The implementation difficulties for such proposals seem insurmountable given the BIK implications for the public service (benefit in kind taxation of public service pensions) and the European direction for a harmonised pensions framework (EET).

The report confirms the serious issues arising for the sustainability of our State pensions. These issues are dominated by the increasing costs of State and public service pensions whereas the costs of private sector pensions (through tax incentivisation) remain static over the medium to long term and represent a reducing proportion of the total pensions cost base over this time.

Chapter 8: Possible Approaches to Pensions Development

We believe that removal of many of the barriers that exist in relation to people taking out pensions is the best means of increasing coverage and adequacy. These should be implemented before any more radical solutions are considered. Any form of mandatory system is likely to undermine the current system. We recommend that the following steps be taken:

- Change the system of tax incentive to one of a direct credit in order to increase understanding and appreciation with an additional incentive for a specified period for new savers
- Allow access to a proportion of accumulated funds before retirement either at a particular event (e.g. house purchase) or at a certain age
- Apply the same rules in relation to tax reliefs, maximum contributions and benefits and options at retirement across all types of DC plans.
- Simplify the sales process for PRSAs and ensure a level playing field all similar pensions savings products

These issues can be addressed at individual and collective level and we see a strong merit in collective arrangements that can target industries or sectors with low coverage rates.

Chapter 9: Issues Regarding DB and DC Pension Schemes

A number of specific issues are raised in this chapter, the first of which looks at integration in defined benefit schemes. Integration is where a scheme takes account of the State Pension in its design in order to target an overall level of replacement income in retirement. Concern is raised that where the State pension rises faster than salaries less income is provided by the scheme. However the individual remains in the same position. The opposite also happens although no concerns are raised then. We believe that integration is a valid aspect of scheme design which is a matter for employers and employees and that State intervention in this area would only increase the decline of defined benefit schemes.

The remaining issues largely cover understanding of risk, security and guarantees. It is important that savers fully understand any risks involved and how these should be dealt with. Such understanding should begin at school level through financial education.

Ireland operates a very secure pensions system with a lot of legislation and regulation designed to protect savings and individuals. Risk reduction is achievable but does come at a cost. A 1% lower return on investments will ultimately require either a 30% greater contribution or a 30% decrease in benefit,

Chapter 10: The Funding Standard

The operation of the funding standard causes huge difficulties for trustees and sponsoring employers, largely because it is measuring a position, and requires action to be taken based on circumstances which for most schemes will not arise i.e. the wind up of the scheme.

We believe the following changes should be made to the funding standard in order to encourage and preserve defined benefit provision:

- Liabilities should be valued on an economic cost basis, removing the link to annuity purchase, and members' interests in the fund should be determined accordingly
- Reviews of funding proposals once put in place should be on an annual basis for information purposes only and should not automatically trigger action if the experience has been adverse. Any requirements for action should only come into effect on a triennial basis in line with the requirement to prepare an actuarial funding certificate and actuarial valuation report
- The funding standard should take into account the specific characteristics and requirements of multi-employer schemes
- Certain schemes with particular characteristics such as a strong employer covenant should be allowed to avail of a scheme specific funding standard

- If liabilities were to continue to be valued on an annuity buy out basis, future increases to pensions in payment should be excluded from the valuation of liabilities for the purposes of the funding standard and should accordingly be re-prioritised that on wind-up such increases would fall to be secured after the benefits of active and deferred members.

Chapter 11: Annuities

Annuity prices in Ireland are approximately 18% higher than a pension scheme's assessment of its corresponding liabilities, largely due to the solvency rules under which annuity providers operate. Almost all the demand for annuities comes from those who have no option but to purchase one; ordinary members of defined contribution schemes. Despite this disparity, trustees still have to use annuity prices to value their liabilities.

We strongly believe that all defined contribution members should have the option to transfer their accumulated funds to an approved retirement fund at retirement. Subject to approved minimum security (e.g. an escalating AMRF or basic level of guaranteed pension) this would allow, members the option to continue to manage their investments on a long term basis rather than be locked into an investment vehicle (an annuity) that can only operate on a low interest rate return for an average period of more than 20 years.

We also believe that the State, which is already the largest payer of pensions in the country, could provide an outlet, in some rare incidences, to take on pensioner liabilities in return for the payment of a capital amount based on the actuarial value of such benefits on an ongoing basis. This would involve minimal risk to the State but would greatly improve the prospects for the continuation of defined benefit schemes and would serve to deliver greater fairness as between public sector and private sector pensioners. Furthermore, this proposal would serve to introduce much needed inter-generational risk pooling through a period of significant change to mortality tables.

Chapter 12: The Role of Regulation

Regulation of pension funds needs to have proper regard to that which is being regulated. It needs to be cognisant of the fact that the entities being regulated are non-profit and exist to provide benefits that are for the social good. While it is in everybody's interest to ensure high standards of governance this objective must be secured in a proportionate manner and the focus should be on those participants and those areas most in need of regulation. Once the objectives of regulation are defined they need to apply equally to the public and private sectors except where distinctions are appropriate (such as the operation of the funding standard). All regulation has a cost and the management of that cost needs to be borne in mind considering that, for the most extent, pension provision in Ireland operates on a voluntary basis, is for the social good and regulation has the potential to destroy that which it is trying to protect. Regulation which focuses on Disclosure must sacrifice messages which would be advantageous in favour of those which are essential. Currently, we have too much detail in the communications which we issue to members and as a consequence we fail to get the focused attention of members to our messages.

Chapter 13: Public Sector Pensions

Public sector pensions are not currently pre-funded. The cost of funding public sector pensions should be viewed in the same way as funding private sector pensions and be subject to regular valuations with pre-funding of at least some of the liabilities. The most recent estimate of the accumulated liabilities was €75 billion and we have calculated the employer contribution (if one had to be paid) in 2006 as €2.6 billion. In addition, €1.6 billion was paid in pensions to retired public servants in 2006.

This contrasts with an annual contribution of €1.7 billion to the National Pensions Reserve Fund (NPRF) which had a value at 31st March 2008 of €19.3 billion. The NPRF was originally established to pre-fund some of the rising costs of the State and public sector pensions. Those costs have risen even further since then and additional funding to the NPRF should be considered.

There is merit in developing, on an ongoing basis, a governance framework and non-political or cross-party infrastructure for the purposes of dealing with the future costs of any increases to the public sector pension liabilities in order to ensure that the sustainability of the public sector defined benefit model is not threatened. This body or process should be instructed to examine the costs of public sector pensions and the scope for reform in order to ensure fairness and equality as between future public sector and private sector pensioners.

Chapter 14: Work Flexibility in Older Age – A New Approach to Retirement

There needs to be a change to many employment, pensions, tax and social welfare rules in order to facilitate a culture of working past the traditional retirement age for those who wish and are able to do so. It may be necessary to try and move away from the concept of retirement as a point in time event and view retirement as something which individuals can gradually transition to.

Chapter 6: The Social Welfare Pension: Reform Options

Questions for consideration:

1. In the light of the reforms to the Social Welfare system undertaken in the 1970s, 80s and 90s which will, in future, see most people qualifying for contributory pensions, are there implications for people who are at present not receiving support through the Social Welfare pension system?
2. Is the introduction of a universal pension arrangement a desirable and feasible option?
3. If universal provisions are not considered appropriate then what groups, if any, currently outside the Social Welfare pensions system should be targeted for action?
4. Policy in relation to pensions has, for many years, concentrated on improving the position of all pensioners. Is this the most appropriate way of improving pensioner incomes or should there be a more targeted approach using measures such as the Living Alone Increase?
5. If the basis of qualification for contributory pensions was changed from average contributions made, to one based on total contributions, what would be an appropriate level of contribution a person should be required to have to receive a full pension?
6. Should a formal indexing arrangement linking pensions to some level of prices, earnings or risk of poverty threshold be introduced? How would a formal indexation mechanism be operated having regard to the overall budgetary and economic position?
7. Given the issues raised in this chapter, in Chapter 3, and in the Green Paper in general in relation to the long-term affordability of existing arrangements, how can the challenge of the growing cost of Social Welfare pensions be addressed?

IAPF Response

The Irish Association of Pension Funds supports an adequate Social Welfare Pension that is sufficient for its purpose, which is to provide for a basic standard of living in retirement. The system should ensure fairness and should be simplified where possible in order to ensure it is easily understood by those who will benefit from it. It should provide for all of those who contribute to society and not just those in the paid workplace. It is important that the system caters for groups such as homemakers, carers and new and returning immigrants in a fair manner.

It should continue to be a single flat rate pension and the level of Social Welfare Pension should be linked to a suitable measure in order to determine the level of pension sufficient for it to achieve its purpose. The level of pension should increase in line with this measure and additional increases should only be made where there is a need and where these increases are costed for and are sustainable.

Any increases to the level of Social Welfare Pension need to be considered both in terms of the immediate costs and the future costs, particularly as the Green Paper highlights the high projected increases in the cost of this benefit. There is merit in developing, on an ongoing basis, a governance framework and non-political or cross-party infrastructure for the purposes of dealing with the future costs of any improvements proposed for the State pension in order to ensure that the sustainability of the Social Welfare pension is not threatened by political decisions designed to garner electoral support at any point in time.

A universal pension would involve a dismantling of the Pay Related Social Insurance model in place in Ireland. There is a strong sense of fairness inherent in the principle of entitlement to benefit based on contributions paid by or credited to an individual. Indeed, it could be argued that the narrowing of the gap between non-contributory and contributory Social Welfare pensions in recent years has undermined that

principle. While nobody would argue with the concept of ensuring there is a safety net available for those who need it, it is also important that incentives are provided to ensure as many people as possible make a positive contribution to society. The Social Welfare system already includes an acceptable element of redistribution in that some individuals pay more than others for the same benefit.

The introduction of a universal pension is likely to increase the total amount of Social Welfare Pensions in payment which would add further to the cost strains in the system. In order to properly consider this option it should be subjected to a rigorous cost/benefit analysis.

A universal pension may have the advantage of simplicity and, assuming real savings could be made in the processes involved in calculating contribution histories, this could have merit. The current system of measuring entitlement by reference to contribution histories seems reasonable and logical at a general level. However, at an individual level it can be very complex and frustrating, particularly where a shortage of a small number of contributions can lead to a significant loss of benefits. However, these savings could only occur if the employees currently carrying out this work were made redundant and this does not generally happen in the public service.

There is also considerable merit in funding the future costs of the Social Welfare Pension through the National Pensions Reserve Fund or some other funding mechanism. This would have the advantage of smoothing the extreme pressures the Pay As You Go system is likely to experience as the ratio of workers to pensioners falls dramatically. Indeed, the recently published Actuarial Review of the Social Insurance Fund as at 31st December 2005 and published in October 2007 demonstrates this. The Review finds that the total income to the Fund is expected to equal or exceed projected benefit outgo until the period to 2010, Thereafter the Fund's net cashflow position is expected to decline rapidly. The Fund's surplus is expected to be exhausted by 2016. By 2021 the yearly shortfall is projected to be €2.8 billion (in real terms) or 1.1% of GNP, increasing thereafter to over €35 billion by 2061 (or 6.4%) of GNP. These figures are very stark, particularly in the context of the current contribution of 1% of GNP to the National Pensions Reserve Fund (NPRF). As the NPRF is intended to pay for the increasing cost of Social Welfare and Public Sector pensions, it is likely that it will be insufficient to do this unless there are increased contributions to the Fund. We suggest therefore that contributions to the NPRF are increased over time to reflect this.

The previous review of the Social Insurance Fund was carried out at 31st December 2000 and there have been significant developments and changes since then. In view of the current projections and the changing nature of the economy, we believe that there should be more regular assessments of the situation in order to be able to properly plan for the future.

In view of the projected increasing costs of the Social Welfare Pension it is important that any future increases in the Social Welfare pensions are fully costed on a long-term basis and not just examined on a current cost basis. In determining increases to the current benefit the nature of the social contract has to be considered and, in particular, a recognition of the fact that too many promises now will put the system under real pressure in the future. The Green Paper provides an opportunity to achieve cross-party support for a formula based method of agreeing increases or a decision process for doing so.

Finally, as many second pillar occupational pension schemes link their benefit design to the Social Welfare Pension, any changes to it need to consider the impact on such schemes in order to avoid unintended consequences. There is further discussion of this issue in our response to Chapter 9.

Chapter 7: Supplementary Pensions – Incentives for Retirement Saving

Questions for consideration:

1. **Can tax incentives be better targeted to encourage improved coverage in a cost-effective way?**
2. **Should the over-riding principle be coverage or equity and should incentives be offered at the marginal, standard or a hybrid rate?**
3. **Should pension arrangements (e.g. the ARF option) differentiate between individuals or be open to all on the same basis? Where is the proper balance to be struck between the competing calls for equitable treatment of all pensioners, appropriate protection for vulnerable pensioners and the costs involved?**

IAPF Response

We have outlined our specific proposals on how tax relief can be better targeted to improve coverage in our response to Chapter 8.

We have also previously submitted a paper on the options available to members of defined contribution schemes at retirement which is attached as Appendix 2 to this response. That paper outlines why the ARF option should be made available to all DC members on grounds of equity but also recognizing the long investment horizon of DC retirees and ensuring suitable investment opportunities are available for those who wish to avail of them.

The system in Ireland operates on a tax deferral basis – pension contributions paid and the investment returns are not subject to tax but the income paid out in retirement is taxable.

IAPF has commissioned independent research, carried out by Life Strategies and attached as Appendix 2 to this response, on the costs and benefits of tax incentives and allowances within public and private sector pensions in order to improve the quality of public debate on how improvements to the State pension might be achieved.

Simplistic modelling of historic data and current cost accounting has failed to provide policy makers with a clear view of the economic consequences of the various public policy options which might exist to enhance the State pension as our population ages. This Life Strategies report provides the essential economic analysis required to properly evaluate the options which are realistically open to the Government.

The analysis undertaken questions the estimate made in the Green Paper of the “cost” of tax relief to the State. The analysis shows that while some of the “costs” have been overstated it is also clear that there are no costs given for the value of public sector benefits which would have to be taxed on a benefit in kind basis if similar changes were made to the taxation basis of private sector pensions.

The report also finds against the argument made that it would be preferable to cease the tax incentives on private sector pensions and increase the State pension with the savings made and clearly evidences how this proposal would exacerbate the sustainability issues that already exist with the State pension. The report quantifies the risk of comparing the relativities of proposed State Pension enhancements and the costs of tax incentivisation on a current cost basis while the projected future costs associated with such enhancements are unsustainable.

In addition, the report establishes that the current cost of incentivisation is not directly transferable to the funding of first pillar pensions.

The reports finds significant implementation difficulties for the diversion of tax incentivisation towards first pillar funding given the BIK implications for the public service (benefit in kind taxation of public service pensions) and the European direction for a harmonised pensions framework (EET).

The report confirms the serious issues arising for the sustainability of our State pensions. These issues are dominated by the increasing costs of State and public service pensions whereas the costs of private sector pensions (through tax incentivisation) remain static over the medium to long term and represent a reducing proportion of the total pensions cost base over this time.

Finally the analysis also calculates the true benefit of tax relief to individuals which takes into account the tax relief received but also estimates the amount of tax that will be paid in retirement. This shows that the net effective rate falls as earnings and contributions increase. Indeed those who do best are on a salary of €45,000 which is interesting as there is a widespread assumption that the incentive system progressively benefits high earners.

It is important that the incentives that are available are used appropriately as any perceived misuse of those incentives adds to the misconceptions regarding their general use.

This report is attached as Appendix 1 of our response.

Chapter 8: Possible Approaches to Pensions Development

Questions for consideration:

1. In the light of the discussion in this Chapter, and giving consideration to the sustainability issue raised in Chapter 3, is the current system of retirement provision, based on a combination of State provision, through the social insurance system, and voluntary provision through occupational and other supplementary arrangements, appropriate? If the current system needs to be enhanced, should higher pensions be provided through social insurance or through supplementary provisions or both?
2. If an enhanced supplementary pension approach to coverage and adequacy is preferred, should it be addressed through changes in the current voluntary system, or by way of soft mandatory or mandatory provision?
3. Can either a “soft” or “hybrid” mandatory pension scheme be designed to ensure that it would not operate to the detriment of the existing voluntary pension arrangements, for example by encouraging movement out of existing systems (which may be potentially better from the member’s point of view) into any new mandatory arrangement?
4. How can the extra costs of enhanced provision be financed? Are improvements in pension coverage and adequacy through enhancement of the social insurance and/or the introduction of a system of soft mandatory or mandatory pensions provision outweighed by the likely costs and economic impacts?
5. Is the introduction of “soft” or “hybrid” mandatory schemes a desirable option given the economic, financial and competitiveness implications of such systems?

IAPF Response

Firstly, it should be noted that Ireland already has a mandatory pension in the Social Insurance system. This performs a specific role in providing for a basic standard of living as outlined in Chapter 6.

It is our strong belief that the best means of approaching pensions development at this point in time is to remove many of the barriers that currently exist to ensuring more people take up supplementary pensions. Possible solutions to many of these issues have been recommended in many reports and consultations previously and have not yet been implemented. We believe that these should be implemented before any more radical steps are contemplated that would have the potential to dismantle the strong voluntary second and third pillar systems currently in place.

Mandatory or soft mandatory systems have the potential to undermine these systems if not completely destroy them. We have real concerns that mandatory or soft mandatory systems set a benchmark that fall below the current levels in terms of contributions paid and benefits provided under existing voluntary arrangements. There are also serious economic consequences of introducing mandatory systems and these have been outlined in previous reports of the Pensions Board. As the economic outlook for Ireland is now quite different from when those reports were prepared it would be necessary to give serious consideration to these issues before taking any action in this area. Furthermore there has not yet been any proper analysis of the real needs and requirements of those who do not currently have pensions coverage.

We would see a strong case for increasing the attractiveness of pensions and encouraging collective type arrangements targeted at those sectors and industries where coverage is low. There is a lot of emphasis on cost in the Green Paper. There needs to be recognition of the fact that improving coverage and adequacy does carry a cost but that the intention is that there will be a real benefit for all of the parties that share in the cost. Generally the “cost” of pensions provision is shared to varying degrees by employers, individuals and the State. The benefit accrues mainly to the individual but the State benefits from the tax

revenue on income in retirement and from a reduced reliance on State benefits and support. Employers benefit in recruitment and retention and retirement allows a natural turnover of staff.

Impediments to Coverage

There are a number of issues that are viewed as being impediments to getting more individuals to save for their retirement. As a means of boosting pensions coverage the IAPF suggests the following issues be addressed in order to make retirement saving more attractive.

During 2007 the IAPF commissioned research undertaken by UCD School of Business to evaluate the attitudes and behaviours of employees in sectors where coverage has traditionally been low. A copy of our final report is attached to this response in Appendix 3. This research enabled us determine the barriers to our common objective of enhancing voluntary participation and coverage. Our findings are supported by similar research studies both in Ireland and abroad.

People find pensions too complex, they do not understand the State incentive and they have real fears and concerns of locking money away for a long period. None of these were issues for the SSIA which is the clearest example of a savings product that captured the imagination of the public and achieved its aim. Furthermore, the SSIA had a limited time period during which it could be taken out and this also provided an incentive and impetus for people to take action. This is evidenced by the fact that almost 50% of SSIA's were taken out in the month leading up to the deadline.

The SSIA approach contained many of the features that the IAPF believes are a necessary part of a successful pensions system, namely simplicity, flexibility, equity and fairness, sustainability and adequacy. Adapting the current system to overcome some of the current real and perceived barriers in place would provide a kick start to the system and make a difference to coverage and adequacy.

Simplicity

Taking out an SSIA was straightforward for an individual in that it consisted of deciding whether to take an equity based or a savings account product. In contrast, taking out a pension can be very complex.

It is relatively straightforward for members of occupational pension schemes as the trustee and/or employer will have done all the work in establishing the scheme. The individual may not even have a choice regarding joining the scheme and will be furnished with explanatory information as required. For individuals taking out personal pension plans it is more difficult as they have to go through a regulated sales process.

There is a similar process for those who wish to take out a Personal Retirement Savings Account (PRSA). In this case regulating the sales process makes little sense as the product has to be approved before it is allowed to be marketed.

The SSIA was also a very simple concept for individuals to understand. For every €4 the individual invested the Government added €1. This directly led to the huge success of the SSIA as individuals saw it as a giveaway. This is somewhat ironic as the incentive given by Government for pensions savings is more beneficial but individuals do not see it that way.

Flexibility

As a product the SSIA was flexible and allowed contributions to be increased to the maximum, decreased or stopped. It was also for a limited savings period which was attractive to people who could see their return, unlike a pension which for those starting seems like forever away.

Sustainability

The Government's contribution was fixed and for a defined period. While it would have been impossible to anticipate how many would take out an SSIA and how much they would contribute we reached the end of the scheme without any particular noticeable consequences. It was therefore sustainable and served its purpose of encouraging more savings in order to keep a check on inflation.

Adequacy

The SSIA allowed individuals to save up to a maximum and therefore they could choose their own level of adequacy. The savings products were only intended to provide a lump sum at the end of the period. The savings accumulated for a pension are converted from a lump sum to an income stream. The individual saver has little advance knowledge of the price and benefit of this and it is therefore difficult to determine adequacy.

The SSIA annual statements showed the individuals' own contributions and the Government contribution which highlighted that by saving more the Government contributed more.

There have been many recommendations in recent years to utilise the positive experience and aspects of the SSIA to encourage individuals to save for their pensions. As mentioned above the research conducted by the IAPF in 2007 concentrated on three sectors of employment that would typically have low pensions coverage – butchers, hairdressers and florists. The survey found that 86% of those without a pension would start one if the Government introduced a simple scheme whereby it contributed €1 for every €1 saved. 91% of those with a pension said that they would increase their contributions. Almost 40% of those without a pension contributed to an SSIA.

We believe that, in order to tackle the main obstacles to getting people to save for their pension the following steps should be taken:

Simplify the sales process

The sales process for PRSAs should fully reflect the fact that it is an approved product that can only be sold if the Pensions Board and Revenue Commissioners are satisfied with its suitability. It should be available as an off the shelf product. Furthermore there should be a level playing field between all similar pension savings product so that there are no differences in tax reliefs or benefit provision and restrictions between PRSAs and other types of DC products – in particular the expansion of the ARF regime (as it applies to PRSA contracts) to occupational pension schemes is an absolute necessity.

Change System of Tax Incentive

The tax incentive should be given as direct credit for all pension savers. There should be an additional incentive for all new savers and for new employees for a limited time period. For new savers this could be for a specified period such as 2 years from introduction and for new employees for their first 2 years of saving.

Access to funds

There should be some access to funds before retirement either event specific (e.g. house purchase) or at a certain age. Any tax free cash taken should reduce the ability to take at retirement and incentivise waiting until retirement.

Level Playing Field

The same rules should apply to all DC pension arrangements in order to ensure consistency and avoid confusion as to which product suits an individual. This should ensure consistency on tax reliefs, maximum contributions and benefits and options at retirement.

These issues can be addressed at individual and collective levels as a combination of these are necessary to increase coverage. We believe it is important to specifically target industries and sectors in which there is currently low coverage through collective schemes that can generally be run on a lower cost than individual products. Many of these industries and sectors will have lower paid workers and high turnover (within individuals employers but less so within the industry). In order for such proposals to work they would need the buy-in of trade unions and employers and could become part of a negotiating framework through social partnership

Chapter 9: Issues Regarding DB and DC Pension Schemes

Questions for consideration

1. Are there problems with the current integration arrangements for DB schemes? If so, what are the possible solutions?
 - a. prohibit integration?
 - b. restrict a reduction in pensionable pay in the last, say, 3 or 5 years?
 - c. have a different integration formula for lower earners, as is the case in the public sector?

IAPF Response

Integration is a logical, rational and valid aspect of benefit design. Employers who put pension schemes in place for their employees are acting voluntarily and in a responsible manner in relation to ensuring their employees are provided for in retirement. In designing those schemes employers decide the level of benefit that is desirable and affordable. Integrated schemes target a total level of income payable to the employee in retirement both from the scheme and the State pension. Any private savings an employee makes through additional voluntary contributions or non pension savings will provide an even higher level of replacement income.

It appears that the concerns cited relating to integration stem from the fact that, in recent years, when increases in State pension have been higher than salary increases, a greater proportion of an individual's income in retirement will come from the State. However the opposite is also true when State pension increases are lower and no similar concerns are expressed.

The provision of private sector pensions on a defined benefit basis is expensive and contains a large element of risk for companies. Any changes to integration arrangements would increase the cost to companies and therefore increases the likelihood of companies ceasing to provide defined benefit schemes or even more schemes closing to new entrants. They would also add complexity to the system as schemes would have to restructure their benefit design. It would be discriminatory for the State to intervene in the design of defined benefit schemes in such a manner. Where a contract has effectively been entered into between an employer and its employees it should not be interfered with and the economic cost of State intervention would not be appropriate.

The IAPF is not aware of any widescale problems with the current integration arrangements for DB schemes and believes that any changes made to this area should only be made if there is a demonstrated need for change. In most defined benefit schemes today the employer is providing the bulk of the funding and it is difficult to argue that members are in any way not getting value for their contributions. While this is an important issue for individuals negatively affected by integration, the overall effect would appear to be overstated. Any changes made to deal with this "problem" could have major cost implications and would also be in danger of having a retrospective effect which would be unacceptable.

With regard to the specific questions posed:

- a. The IAPF would not support this proposal as it would increase the overall cost of pension provision and increase the likelihood of employer ceasing to provide defined benefit schemes.
- b. It is common practice in the private sector to deal with this issue on a discretionary basis and therefore it would be important to research the extent of this issue before making changes in legislation that may end up having unintended consequences. Indeed the biggest cost impact of such legislation is likely to fall on the State. In any case, this is not an issue to legislate for.
- c. The IAPF does not believe that this proposal has merit. The provision of private sector pensions is voluntary and involves considerable cost and risk. The number of companies offering defined benefit

schemes is falling and the IAPF believes that legislating for a particular approach to defined benefit design is not warranted and would simply lead to a further move away from defined benefit.

As an example of how integration works in practice consider an individual earning €20,000 per annum. The current State pension is €223.30 per week or €11,611.60 per annum. The scheme is designed to provide 1/60th of salary per year of service or 2/3rd of salary after 40 years service. In an integrated scheme, pensionable salary is defined as salary less 1 ½ times the Social Welfare pension. The benefit calculation for someone at retirement with 40 years service is as follows:

Salary	€20,000
State Pension	€11,611.60
Pensionable Salary	€2,582.60 i.e. €20,000-(€11,611.60 x 1.5)
Scheme Pension	€1,721.73 i.e. €2,582.60 x 40/60
State Pension	€11,611.60
Total Retirement Income	€13,333.33 (2/3 of final salary)

If integration was prohibited and the scheme used the same formula the outcome would be:

Salary	€20,000
State Pension	€11,611.60
Scheme Pension	€13,333.33 (i.e. €20,000 x 40 / 60)
State Pension	€11,611.60
Total Retirement Income	€24,944.93 (125% of final salary)

In the first outcome the individual ends up with an income of 2/3rd of final salary which is greater than the stated NPPI target of 50%. In the second scenario the individual ends up with a pension which is 25% more than their salary. This type of outcome would not be sustainable from the scheme's point of view and makes little sense in any case.

It should also be noted that the individual's contributions (if the scheme is contributory) will most likely have based on the integrated pensionable salary.

2. How can we ensure that savers understand that the level of contributions, the length of time the contributions will be made, and the return on investments will influence the level of benefits in a DC scheme?

IAPF Response

This is largely a communications and education issue. As well as the issues mentioned in the question it should also be remembered that the level of benefits in a DC scheme will be influenced by the annuity rates prevailing at the retirement date of the individual saver. The effect of this can, we believe, be mitigated by allowing all DC members reaching retirement age to avail of a transfer to an Approved Retirement Fund should they wish to do so and should it suit their circumstances.

The requirement from 1st January 2009 to provide Statements of Reasonable Projection should provide members with greater understanding of the issues specified. This is in addition to a plethora of information members are obliged to be provided with through the Disclosure Regulations.

In view of the level of information provided to members of schemes it should be recognised that it is the primary responsibility of individuals to ensure they have adequate retirement savings for their particular needs. Industry practitioners can and will be prepared to support any initiatives in increasing adequacy but it is not their responsibility to ensure adequacy.

Many DC schemes already provide members with access to projection calculators, similar to that available on the Pensions Board website. Trustees therefore recognise the benefits such tools can offer. These tools can play an important part in highlighting to employers and employees when savings levels

are not sufficient to attain desired outcomes. Traffic light warnings can also be useful in delivering simple and effective messages to employers and members regarding adequacy.

It may be possible to increase the quality of information or guidance around these issues by examining the level of detail provided to members. Providing less information with greater clarity would be more effective in getting this message across. Disclosure regulations on “basic information about the scheme” could be refined to include relatively simple statements to the effect that these factors (level of contributions, the length of time contributions will be made, the return on investments and prevailing annuity costs at retirement) will determine ultimately the benefits payable. Such a requirement may encourage Trustees to provide more detail on these issues in their booklets. This could take place in conjunction with a simplification of the current disclosure regulations to make them more relevant to DC savers with more principles based requirements.

General understanding of this issue can be improved by awareness campaigns focusing on adequacy. The Pensions Board could also emphasise these issues in their Pensions Awareness campaigns which could encourage employers, trustees and employees to have regular “health checks” of their pension provision. Too many individuals think in terms of “I have a pension” without checking what it is likely to provide.

Issues such as these are becoming more important to the financial and overall welfare of savers as savings are becoming more individualised. In order to allow people to understand these issues and be able to plan for their financial futures, there should be more emphasis on such issues in the education system. All students at second level should study financial planning subjects that will educate them on the major financial decisions that they will encounter later in their lives.

3. What would be considered appropriate security of pension benefits? Does this exist at present?

IAPF Response

The sections in the Green Paper that consider security of benefits largely appear to equate security with guarantees of outcome. It should be remembered that Ireland has a very secure pensions system that is overseen by a regulator, the Pensions Board, or to some degree by the Financial Regulator. There is also an Office of Pensions Ombudsman in place to ensure that individuals can seek financial redress for maladministration. Furthermore claims can be made to the Insolvency Fund where an employer goes into liquidation and has not been paying contributions to the pension fund.

Pension schemes are set up under trust and therefore there is legal separation of the assets of the scheme from those of the employer. The trustees oversee the running of the scheme and therefore provide a governance structure. They are also subject to legal requirements and penalties and sanction.

There is therefore a structure in place that provides for the security of funds and benefits. When looking at guarantees in the context of DC schemes, this relates to expected investment returns and awareness of the risks associated with various types of investment. Any guarantees in investment return would have to be underwritten by either sponsoring employers or the State and this would require major changes to the pension system. In the absence of these changes “appropriate security” of benefits for DC scheme members can be enhanced through awareness of the risks and the encouragement of members to engage with the management of their retirement funds and investment strategies. Many members however are not equipped to do this either through lack of understanding or lack of information. The answer therefore is in educating members regarding the risks in investing in various asset classes, by assisting members to identify their objectives and personal appetite for risk, and in understanding that they can adopt investment strategies aimed at achieving those objectives while managing the risk.

The extension of the Approved Retirement Fund options to DC members’ total funds (as with personal pension plans, Personal Retirement Savings Account holders and proprietary directors) would remove the risk associated with fluctuating annuity rates at retirement, a factor that currently cannot be managed by members.

Some schemes and funds use “Lifestyle” options to reduce the amount of risk individuals are exposed to as they approach retirement. Any method of reducing risk generally involves reducing returns which can obviously have a very detrimental effect on benefits. The extension of the ARF option to DC members would in many cases negate the need for lifestyle funds as DC members could continue to take a long-term investment view as they continue to be investors post-retirement.

For defined benefit schemes the issue of security is closely tied to communication of the pension promise. The IAPF believes that currently there is a divergence between the actual level of security provided by defined benefit pension schemes and the level of security perceived by members of defined benefit pension schemes and that desired by regulators. This gap should be bridged and a valid approach would be to improve the level of knowledge of members in relation to benefit security (e.g. by advising them that their benefits are only defined to the extent that the pension scheme has sufficient funds to back those liabilities). It is also important to remember that the Funding Standard was put in place to increase the level of security for members of DB schemes. The fact that there are rules about measuring the financial position of DB schemes and steps that must be put in place to address shortfalls where they arise provide additional security to members.

Any hardening of the guarantees which apply must be balanced with the fact that it will have two undesirable results: the cost of providing benefits will increase and either the number of companies offering defined benefit schemes will fall or benefits will be reduced.

The exposure to, and risk of, divergence between asset and liability valuations at any given point in time is a fundamental part of defined benefit provision. Defined benefit schemes cannot operate with zero risk as the resultant cost is unsustainable. The question is therefore whether the operation of defined benefit schemes with risk is better than not having defined benefit schemes at all. The IAPF is not alone in holding the view that the risks associated with defined benefit schemes are worth carrying having regard to the scale and quality of defined benefits being delivered in retirement.

We believe the system could be improved by the introduction of flexibility to alter accumulated benefits in circumstances where an alteration of accrued entitlements can ensure the continued of benefit and can be agreed with the members.

4. Are people sufficiently aware of the trade-off between risk and the return on investments, i.e. usually the higher the potential return, the greater the risk?

IAPF Response

While many people are aware of this trade off experience shows that a reducing but still significant proportion of DC scheme members are not. This is evident in the investment choices made by some members without due regard for their appetite for risk and retirement objectives and by the fact that many members rarely adjust the fund choices they make on joining the scheme throughout their membership of the scheme. Again, this is a matter of education and the Disclosure requirements regarding investment alternatives will assist with this. However, the information is only required to be provided on request to a member. It may be of benefit instead if such information were to be provided automatically, say on becoming a member of the scheme, as part of scheme booklet or separate handout; where additional fund options are introduced or with annual benefit statements.

5. What could be done to enhance guarantees of pension benefit? Do guarantees justify the associated costs and risks?

IAPF Response

This has largely been covered in the response to Question 3. However it should again be emphasised that guarantees come with a considerable cost. In order to cover this cost individuals either have to accept lower returns and therefore lower benefits or have to pay higher contributions. A 1% lower return will

ultimately require a 30% higher contribution to achieve the same benefit or result in a 30% decrease in benefits. There has been a lot of emphasis on guarantees and perhaps the real issue should be about how to better manage risk. It is possible, although often difficult and costly, to structure products that are more innovative and diversified that can address this.

6. **In some countries, there are arrangements to meet at least part of a shortfall in the event of a scheme shortfall. Some of these arrangements include the Pension Protection Fund in the UK, the Pension Benefit Guarantee Corporation (PBGC) in the USA and the German Pensions-Sicherungs-Verein. These arrangements can run into considerable difficulties, with the experience of the PBGC, which is currently experiencing large deficits, being a particular case in point. Having considered the discussion, would you be in favour of any of these arrangements, having regard to the pros and cons outlined in this chapter?**

IAPF Response

Internationally, there appears to be no suitable model for the operation of a national pension protection system. When pension schemes experience pressure, the same pressure affects multiple schemes so nationally there are years when hardly any pension schemes experience pressure while there are other years when most pension schemes experience pressure.

The IAPF believe that further consideration should be given to incorporating an element of discretion into the benefit design of pension schemes (e.g. discretionary pension increases or even part of the core retirement benefit being discretionary). This currently operates in the Netherlands where indexation is conditional on the funding position of the scheme and acts as a pressure valve in times of valuation distress.

A key difficulty with many defined benefit schemes is that if every benefit is defined absolutely with no flexibility then the corollary is that the contributions should be completely flexible. In reality there is a limit to the level of contributions which would be entertained by most pension scheme members and employers so that a defined benefit scheme with no discretionary element is to an extent dependent on positive experience. We believe that consideration should be given to the incorporation of 'safety valves' in the form of discretionary benefits to make pension schemes more viable when scheme experience (whether investment or mortality or salary inflation) is adverse. We believe that this would be in the best interests of pension scheme members as it would be preferable when a scheme is unable to meet its full benefits to modify those benefits rather than wind-up the scheme.

IAPF has recommended for some time, the establishment of a State Annuity Fund, designed to provide protection for members of DB schemes that wind up in deficit. This is covered in more detail in a separate submission on the Funding Standard and is attached to this response at Appendix 4. We believe that such a Fund can operate on a basis that is cost neutral to the State but would provide an important form of protection for such members and would redress some of the current imbalance between public and private sector pensions.

Chapter 10: The Funding Standard

Questions for consideration

1. Are there any particular difficulties with the funding standard? If so, what are these difficulties and what implications do they have in your opinion?

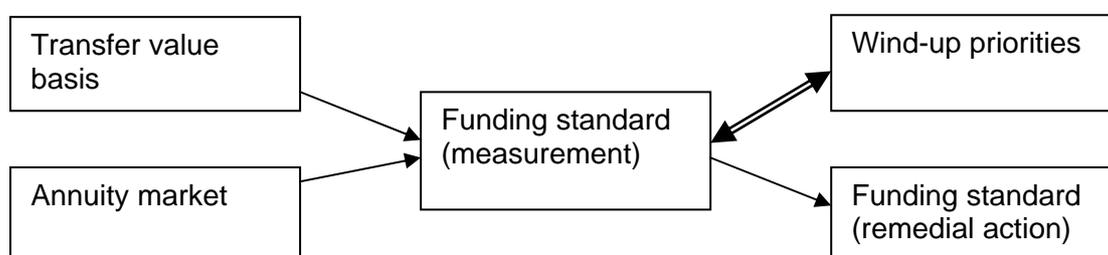
IAPF Response

The operation of the Funding Standard causes huge difficulties for trustees and sponsoring employers. As a measurement tool the funding standard measures a scheme's liabilities on the basis that the scheme is winding up. Where the assets of the scheme are not sufficient to meet its liabilities (on the wind up basis) the scheme has to put a recovery plan in place until the assets are sufficient to do so. This measurement does not in any way take into account the likelihood of the scheme to wind up and therefore many schemes have to put a recovery plan in place to deal with an event that is not going to happen.

This recovery plan has to be signed by the trustees, employer and actuary. Putting such a plan in place often involves negotiations with employees and/or trade unions as their benefits or contributions may be affected. Approval of overseas based parent companies can also be required. It can therefore take considerable time and effort to get a plan agreed. One of the reasons that putting a funding plan in place is so difficult is that there is no scope for trustees to reduce benefits that have already been accrued. In many schemes benefit improvements were made when the funding level of the scheme was strong but those benefit improvements may now be the reason the scheme is in difficulty. This is often true of schemes where guaranteed increases to pensions in payment were added to the benefit structure. However, it is then subject to annual review and even slight deviations can result in a new plan having to be put in place. One way of dealing with a funding difficulty would be to allow trustees to remove those benefit improvements but this is currently prohibited by legislation for any benefits already accrued.

The funding proposal process can become extremely frustrating, particularly where it has to be revisited. The process is also costly and it would be better if some of the money spent on measuring and putting together new funding proposals was invested in the scheme. Current market volatility is evidence of how quickly a situation can change and even how shortlived any particular change can be. We believe that the situation should be measured on an annual basis but that there should not be any automatic trigger for action to be taken. The trustees would always be in a position to decide if further action is necessary but this could be taken without being under a regulatory deadline.

The Pensions Act inextricably links the funding standard with the priorities on wind-up, but more fundamentally, a number of areas become intertwined as a result of the Act.



Many schemes do not buy annuities when members retire. In particular virtually no large schemes buy annuities for retiring members.

Very few defined benefit transfer values are taken up with the result that most transfer value calculations are effectively for disclosure purposes or to form part of a funding standard calculation.

} To emphasise, in respect of many schemes, the measurement of liabilities for the purposes of the funding standard is purely hypothetical and has no bearing on the day to day operation of the scheme.

The fact that the scheme liabilities are measured in terms which are artificial for many schemes is not in itself a problem.

The key difficulties arise subsequent to this measurement of the scheme liabilities and are:

- a. Once the funding standard liabilities are measured, there is a requirement that any deficit (regardless of size, regardless of the probability of a scheme wind-up) must be addressed through a funding proposal.

There is a further requirement that the funding proposal be revisited annually. Typically a funding proposal aims to right the deficit over 3-10 years and this annual check on its progress, with the potential for further remedial action creates excessive short-term pressure (as already outlined) when the aim should be to ensure that the scheme's finances are on the right footing over the long-term.

- b. If the scheme cannot continue (and one of the reasons could be that the funding standard accelerates the funding required), then the wind-up priorities give significant protection to some members and disadvantage others.

We note that this has also been highlighted by the OECD in their Economic Survey of Ireland, 2008. In that report the OECD state that "the current emphasis on a "wind-up" test, that requires schemes to be able to buy annuities if the scheme were to close immediately, does not adequately reflect the future funding needs of pension funds and may encourage investment in low-yielding assets".

In summary, our position is that we would have no particular issue with the funding standard if its role was to measure scheme funding in a standardized manner. We do have a problem with the consequences of schemes not meeting the funding standard as indicated under a. and b. above.

2. **Should the funding standard be based on long term expected returns, but leaving the current wind-up entitlements unchanged?**

IAPF Response

The IAPF is firmly of the view that the current wind-up entitlements are deeply flawed for two reasons:

- **Firstly**, the way in which pensioner and active/deferred liabilities are measured is different. We believe that the entitlements of all members should be measured in a uniform manner.

To elaborate, we believe that a single formula should apply across the board (to arrive at the member's notional interest in the scheme) and in the event of a scheme wind-up, the assets would be distributed in proportion to the members' notional interests in the scheme. Subsequent priorities could then provide, amongst other things, for the additional cost of annuitisation of pensioner liabilities.

The reason for this is to ensure a greater degree of equity among all of the members of the scheme in a wind up situation rather than the current situation which provides additional protection for some members at the expense of others.

To recognize the implementation issues of a change in the order of priorities we propose that in a wind up situation the scheme liabilities would be discharged as follows:

- Pensioners who retired prior to the effective date of the change in legislation would continue to have their pension secured on an annuity basis (without future pension increases)
- All other members, including pensioners who retired after the effective date of the change in legislation, would be distributed assets based on their interest in the scheme on an economic cost basis
- Any surplus funds would be used at the discretion of the trustees and in accordance with the rules of the scheme but could be used to enhance the pensioner distribution to an annuity cost basis.

For active/deferred members, the resultant funds could be invested as currently for instance in a Personal Retirement Bond or Personal Retirement Savings Account, while for pensioners not annuitised, the resultant funds could be invested in an Approved Retirement Fund.

- **Secondly**, the priority accorded to pensioners takes no account of the interest in the scheme of members prior to retirement.

Extreme examples are useful to illustrate the inequity of the current system. While examples along these lines have been submitted to the Pensions Board in the past, we illustrate the issue in the example below:

<p>Example</p> <p>Initial position</p> <ul style="list-style-type: none">- Defined benefit scheme with 10 members – all active, no deferred/pensioners- Pension $1/60^{\text{th}}$ of salary per year of service- 2007: funding standard liabilities of €1.35m; assets of €1.35m- Managing director – salary €100,000, age 65, service 40 years- Other members – salary €20,000, average age 45, average service 20 years <p>Change</p> <ul style="list-style-type: none">- Managing director retires- Pensioner liabilities invested in bonds; other asset values fall 15% - 5% overall fall <p>New position</p> <ul style="list-style-type: none">- Liabilities increase from €1.35m to €1.55m- Assets fall from €1.35m to €1.30m- Pensioner's benefit worth €1.1m – fully protected- Other members' benefits worth €45k – 41% or €19k available on wind-up
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In the event of the scheme winding up after a 5% fall in the asset value, our approach would result in the pensioner receiving 95% of the economic value of his pension to be invested, at the members discretion, in an AMRF & ARF or to be annuitised. This, of course, would be insufficient to purchase an annuity but would reflect the amount of his interest in the scheme.

The active members would also receive 95% of their interest in the scheme.

3. Should the link between the funding standard and wind-up entitlements be broken?

IAPF Response

Whether the two are linked or not, the wind-up priority entitlements are inequitable.

We do not have a particular issue with the disclosure of the funding standard position based on the hypothetical position of the scheme on wind-up.

However, we do not believe that a scheme with a funding level of less than 100% on a wind-up basis automatically requires remedial action.

We have in the past proposed that some schemes could be exempted from the requirement to take remedial action where they satisfy some (not all) of the following criteria or have other circumstances which are considered relevant:

- (a) Liabilities greater than a specified amount
- (b) Substantial employer covenant:
 - a. Capital value
 - b. Turnover
 - c. Staff numbers
 - d. Customer base etc.
- (c) Consultation with members on the nature of the Scheme Specific Standard being requested
- (d) Sustainability of pension provision

This concept is already present in pensions legislation as certain employers are exempted from all aspects of the funding standard as there is deemed to be a particularly strong employer covenant where the State is the ultimate guarantor of funding.

4. Should the funding standard remain unchanged?

IAPF Response

We believe that a funding standard based on the long-term cost of providing the benefits under the scheme would be the most desirable framework.

However, we believe that the funding standard could remain in place if the wind-up entitlements were reworked to reflect the members' interest in the scheme and if a funding level of less than 100% did not automatically trigger remedial action in the form of a funding proposal with accelerated funding or other features.

We also recommend that that the funding standard takes into account the distinct characteristics and requirements of multi-employer schemes. These schemes have a major role to play in allowing access to defined benefit provision through a collective arrangement to employers and employees where this would not otherwise be feasible. The provisions of the funding standard should not in any way inhibit the ability of these schemes to continue to operate in a manner that provides sufficient protection to employers and the members of those schemes.

5. Should the benefit entitlements underlying the funding standard be reduced in value, thereby reducing member entitlements in the event of a wind-up happening, as compared with the current standard?

IAPF Response

We believe that in the event of wind-up, all members' interests in the scheme should be assessed on the same basis to avoid anomalies associated with for instance retirement and furthermore, we believe that all members should have equal priority based on their interest in the scheme.

There is also a strong basis for establishing a State Annuity Fund into which the assets of schemes that wind up when underfunded could be transferred. This would mean that those benefits would not have to be crystallised and could be managed.

We accept that some protection of existing pensioners (e.g. pensioners up to the effective date of a change in legislation) may be necessary to achieve a workable change in this area.

These positions have been outlined by the IAPF on many occasions over recent years and there has appeared to be very little appetite to take these changes on board. We do believe that they can make a real difference to the continuation of DB schemes and more closely reflect how they operate in practice. There is a disconnection in measuring schemes with reference to an event that hasn't happened and, for most schemes, is unlikely to in the near future. One can understand the desire to protect members of schemes in situations where a scheme could wind up without sufficient assets to cover its liabilities. However, as has been demonstrated, the current funding standard does not achieve a required level of protection for all scheme members.

One relatively straight forward change that would address this issue would be to move pensioner increases from the calculation of pensioner liabilities to the bottom of the priority order. The effect of this would be that, in a wind up where total assets are less than the total liabilities, the pensioners would continue to receive their pension at its current level. Remaining funds would then be used to pay transfer values for active and deferred members and only after these have been secured would any remaining funds be utilised to provide future increases to pensions in payment.

In calculating whether or not a scheme met the funding standard, guaranteed future pension increases would not need to be included.

We believe this is the approach most likely to gain the greatest degree of consensus, as this is an issue on which it would seem unlikely to ever be able to get complete agreement. Again, we appreciate that flexibility may be required to grandfather benefits of those already retired and in receipt of benefits at the point of legislative amendment.

6. Should the funding standard be changed for large DB schemes only?

IAPF Response

We believe, as already outlined, that there is significant scope and need to change the funding standard although we would not link this exclusively to large schemes. A scheme specific funding standard could be applied to schemes that contain particular characteristics as outlined in response to question 3. There is no reason why a small scheme with a very strong employer covenant, for example, could not be subject to a scheme specific standard.

Summary

We believe the following changes should be made to the funding standard in order to encourage and preserve defined benefit provision:

- Liabilities should be valued on an economic cost basis, removing the link to annuity purchase, and members' interests in the fund should be determined accordingly
- Reviews of funding proposals once put in place should be on an annual basis for information purposes only and should not automatically trigger action if the experience has been adverse. Any requirements for action should only come into effect on a triennial basis in line with the requirement to prepare an actuarial funding certificate and actuarial valuation report
- The funding standard should take into account the specific characteristics and requirements of multi-employer schemes
- Certain schemes with particular characteristics such as a strong employer covenant should be allowed to avail of a scheme specific funding standard
- If liabilities were to continue to be valued on an annuity buy out basis, increases to pensions in payment should be at the end of the priority order on wind-up, should only be provided after benefits for active and deferred members were secured and should be removed from the calculation of liabilities for the purposes of the funding standard.

Chapter 11: Annuities & Related Issues

Questions for consideration

1. Do annuities offer value for money?

IAPF Response

The regulatory regime under which annuity providers operate makes annuities expensive largely due to solvency requirements and capital cost. The Review of the Irish Annuities Market carried out by Indecon and Life Strategies is very incisive and accurate. This report finds that, in terms of the price of annuities relative to a defined benefit scheme's assessment of its pensions liabilities, that annuity prices could be expected to be approximately 18% higher than a pension scheme's assessment of its corresponding liabilities. The cost of capital accounted for the biggest difference, accounting for 6%, mortality differentials accounting for some 5%, a planned profit margin of over 3% and commission and expenses accounting for 3%. These findings corresponded closely with previous findings by the IAPF which suggested a 15% differential for these factors as well as the Society of Actuaries in Ireland. It should also be noted that the cost of capital will have increased since the review was being written due to the credit crunch in global markets.

It is also clear from the Review that demand in the annuity market is dominated by those who have no choice but to purchase one. Most individuals and trustees who have an option are choosing not to and are instead transferring to Approved Retirement Funds or paying pensions from a scheme. There are a number of reasons as to why individuals and trustees make this choice but it is clear that the perception of value for money is one of the primary ones. What is of particular concern for trustees is that, having made a decision that buying an annuity is not appropriate for their scheme, they then have to, because of the Funding Standard, value their pensioner liabilities by reference to the annuity market where prices are almost 20% higher.

2. Should DC holders continue to be compelled to buy an annuity at the precise moment of retirement or should they be allowed some flexibility in timing? Should PRSA and other personal fund holders continue to be allowed to avoid annuitisation and to continue to hold their retirement funds until death?

IAPF Response

The IAPF response to this question has already been submitted and we strongly believe that all DC holders should have the option of transferring to an Approved Retirement Fund. This response is attached at Appendix 2 and was published as a paper "Defined Contribution Member Options – Annuities and Approved Retirement Funds" in November 2007.

3. Should the State be more involved in the annuity market and, if so, in what way? Is it appropriate that the State takes on the additional risk involved in the form of a State Annuity Fund?

IAPF Response

The IAPF has previously published a Discussion Document on the merits of a State Annuity Fund and a copy of this document is attached to this response at Appendix 4.

The State is already intensively involved in the annuity market in that it pays more pensions than anyone else in Ireland. In 2005 the Department of Social & Family Affairs were making payments to 438,282 recipients of Social Welfare Schemes aged 66 and over. Furthermore, pensions are being paid by the State to approximately 80,000 pensioners who are former public and civil servants. This is in comparison with approximately 70,000 pensioners being paid by IAPF members.

Therefore the State already has a structure in place for paying pensions and already has a large accumulated pension liability. Further State involvement would also provide a balance to public and private sector provision as all taxpayers are currently paying for the existing State involvement in the annuity market but not all benefit to the same degree.

The IAPF believes that there is merit in the State providing an outlet to take on pensioner liabilities in return for the payment of a capital amount based on the actuarial value of such benefits on an ongoing basis. Indeed, were the State not to allow all DC members to have the option of transferring to an Approved Retirement Fund it must allow some other form of flexibility.

A State backed annuity purchase scheme would enable the Pensions Board to propose an advance funding system on a discontinuance basis but with the flexibility to allow employers elect (with trustee and Pensions Board consent where the best interests of the members dictate) an ongoing funding approach with additional security such as a voluntary lien on employer assets. The State backed scheme would then provide an additional safety net in instances where involuntary insolvent wind-ups occur and where the employer has insufficient assets to satisfy the difference in assets between the ongoing liability in respect of pensioners and the annuity cost for such purchase.

We do not believe that this proposal involves the State taking on additional risk relative to the risk it already carries as any additional risk is minimal and recoverable. Indeed, a study of this issue completed by Hewitt Associates as part of the National Pensions Review concluded that a limited State involvement along the lines suggested by IAPF would limit the State's exposure and costs.

We strongly believe this does not involve any great cost to the State but can make a big difference to the funding requirements of defined benefit schemes. This would encourage the continuation of such schemes which has to be of benefit to the State as they are the most likely to provide adequate benefits to pensioners and reduce reliance on direct State provision.

Under the framework we have previously suggested the State could agree to accept assets at the ongoing valuation rate in exchange for the payment of the pension to the member and this would allow the State at a no cost basis to provide the protection necessary in order to underpin the defined benefit system.

In this environment it would also be possible to envisage that in insolvent wind up pensioners could be offered the option of transferring their benefits to an Approved Retirement Fund at the actuarial valuation or ongoing value of those liabilities rather than the annuity cost. This may well suit some pensioners and would also relieve the position regarding the funding of deferred members and active employees. It is probable that the system, in such circumstances, would have to also be amended to allow ARF options for pensioners on solvent wind up to ensure that the range of options available for members of an insolvent wind up is freely available to all, i.e., that pensioners on insolvent wind up are not preferred.

The advantages of a proposal in this regard are to allow employers to elect to fund schemes on an ongoing basis. In return, it is proposed that employers' commitment to continue to fund such schemes is underpinned by a voluntary assumption by the corporate entity of a "lien on employer assets". This lien would apply in circumstances where the scheme is subsequently wound up and has insufficient assets to secure annuities for pensioner liabilities.

In addition the current funding standard framework would not require a significant alteration as the existing funding standard would remain in place and an ongoing funding standard would merely be an option for the trustee / employer election subject to Pensions Board consent under Section 49(3).

The establishment of a State backed annuity purchase scheme can be supported by the following arguments.

- It will only apply in the event of involuntary insolvent wind-ups (i.e., where the employer has gone into liquidation) and where there are insufficient corporate assets to satisfy the "lien on employer assets". The incidence of such events could reasonably be expected to be low.
- It would not necessarily require any substantial State funding and therefore as an alternative to a pension protection fund, avoid the imposition of levies on either the taxpayer or the pensions system.
- It would operate on a basis where, on the insolvent liquidation of a sponsoring employer, an insolvent scheme would transfer to a State backed fund the actuarial equivalent (calculated on an ongoing basis) of the pensioner liability.
- The fund could be invested on an ongoing basis with an equity/bond mix and should not be subject to EU Life Directive regulations or IORP's investment principles. As such the fund ought to be able over the long term to satisfy the pension liabilities from the assets paid into the fund.
- The incidences of involuntary insolvent wind-ups are unlikely to be materially significant (in terms of the number of such occurrences arising).
- There are numerous third party administrators who would be willing to operate a pensions payroll system, thus eliminating any administrative burden on the State. Costs associated with this administration would be included in the actuarial basis for determining the costs of benefits.
- Equally, the investment of the fund's assets could be managed by private sector trustee and investment manager appointments to further eliminate administrative burden on the State, or otherwise by the NTMA using the NPRF. Costs associated with this operation and investment management fees would be included in the actuarial basis for determining the costs of benefits.
- The existence of such a scheme may be seen to prefer members of defined benefit schemes. As such, it may be appropriate to simultaneously introduce the extension of the ARF regime to all defined contribution members. As a compulsory vehicle, annuities are not appropriate for long term post retirement investment in a climate of low interest rates.
- The existence of such a scheme would allow further flexibility in the Funding Standard and encourage the continuation of defined benefit schemes.

4. What measures could be introduced to assist individuals to recognise annuity terms that they may find satisfactory?

For example:

- **Are there steps which could be taken to better inform customers in relation to the comparative cost of annuities?**
- **Should providers be obliged to inform a prospective purchaser that their annuity can be bought from a different provider?**
- **Should measures be introduced to encourage people to look at alternatives to fixed single life annuities?**

IAPF Response

- Yes. We suggest a comparison is produced on a regular basis by an independent body, such as the Financial Regulator or Pensions Board to look at annuity levels in monetary terms in lieu of a certain fund on a number of different bases (guarantee period, escalation, spouse's annuity). It would be important to consider comparisons in terms of the annuity amount per annum as opposed to percentages as some providers build charges into the percentage quoted where others do not. Therefore, the only true comparison is to rate amounts per annum.
- Yes.
- Yes, it should be noted here that the Occupational Pension Schemes (Disclosure of Information) Regulations, 2006 introduced a requirement (effective 1 January 2007) that the information given to a member on retirement must include an explanation of the option available to take a level pension with no subsequent increases or a lower initial pension that would increase in payment.

It should be remembered that giving too much information can serve to confuse rather than inform individuals.

5. How can the market for annuities be encouraged to diversify and become more competitive? Can measures be taken to encourage new entrants to enter the market?

IAPF Response

The annuity market operates on a commercial basis and it is difficult to see what steps can be taken in this area that don't create a false market. The solvency requirements annuity providers are subject to make annuities expensive. The report carried out by Indecon and Life Strategies would indicate that there are no barriers to entry to the Irish annuity market. There are concerns regarding the small number of market participants. We believe this could cause a serious issue in the (unlikely) event of a large scheme winding up and needing to purchase large amounts of annuities. We believe that the establishment of a State Annuity Fund would address this issue. The development of alternatives such as variable annuities, ARFs and AMRFs may be more appropriate and relevant.

- 6. In what ways can employers and trade unions be more proactive? Can more information be provided about annuities and the options available when employees are coming up to the point of retirement?**

IAPF Response

The current Disclosure Regulations already require detailed information regarding options to be presented to members coming up to retirement. It is difficult to see why there should be further obligations on employers and trade unions in the run up to retirement. This is more of a general education and communications issue. Members of schemes should be educated to know the issues they need to be addressing as individuals as part of their preparation for retirement and need to take more responsibility in order to be able to make the choices that suit their individual circumstances. This education needs to start at school level in order to ensure that individuals have a basic understanding of the major financial decisions that are going to face them in life.

Chapter 12: The Role of Regulation

Questions for consideration

- **Is the overall approach to the regulation of pensions appropriate to ensure confidence and security in the system?**
- **Are the regulatory objectives appropriate?**
- **Is the level of regulation appropriate to the regulatory objectives we are trying to achieve?**
- **Are there measures that could be taken to introduce transparency in relation to pension fund charges?**

IAPF Response

Is the overall approach to the regulation of pensions appropriate to ensure confidence and security in the system?

The key challenge of regulation is balancing the provision of confidence and security in the system with the practical day to day operation of pension schemes. In order to achieve this balance there needs to be recognition of regulatory cost and an absolute justification of any additions to this cost. This is especially important in a system where pension provision by an employer is voluntary.

Regulators are often established to ensure that something which has been shown to be wrong does not happen again. Quite often there are many things that a regulator simply cannot prevent and it would be wrong to expect that any regulator could prevent all potential problems.

To attempt to do so would result in a regulatory burden that would cause schemes to close, leading to the worsening of the position of those the regulator is trying to protect. The real challenge of regulation is to get that balance right and ensure that regulation does not destroy what it is seeking to protect.

The volume of legislation and regulations relating to pension schemes has increased dramatically since commencement in 1990. The consolidated version produced by the Pensions Board runs to over 800 pages. This is constantly added to and very little is taken away. While it is clear that regulation must develop over time it is important that there are strong processes in place to ensure new regulation is necessary, justifiable and practical. It can be difficult to move from the theoretical to the practical yet this is a crucial aspect of ensuring the regulatory objective can be achieved in a practical manner.

In order to achieve this, the regulator should have appropriate resource to consider the effects of proposed regulation. It is also important that there is a strong consultation process with those who operate pension schemes to ensure that there are no unintended or disproportionate effects of new regulation. When it comes to enforcing regulation it is imperative that there is a balanced and reasonable approach taken. There should be a proper weighting given to the importance of issues and any actions taken should be proportionate.

There is a lot of focus on disclosure of information as a key means of regulating. This has resulted in members of schemes being provided with detailed prescriptive information they do not read or may not understand. This information is produced at considerable cost and is often not adding any value. This is an ineffective use of resource.

▪ **Are the regulatory objectives appropriate?**

IAPF Response

The regulatory objectives listed would appear to be in reality a mixture of regulatory and policy objectives. The regulatory objectives that apply to occupational pension schemes would appear to be:

- To ensure that savers receive the benefits to which they are entitled under the terms of their pension arrangement
- To ensure that monies contributed for retirement savings are not misappropriated and are properly accounted for
- Where savers have investment choices under defined contribution schemes, to provide enough information to make investment decisions
- To provide pension savers with the information they need to make specific decisions, for instance at retirement/withdrawal
- For defined benefit arrangements, to ensure that the scheme is being funded at a rate that is appropriate to the benefits promised
- To make sure that the investments of the scheme are appropriate to objectives and expectations of scheme and its members,
- To prevent discrimination in scheme access or provision

The regulatory objectives focus on receipt of benefits, providing information and funding. On an overview basis, the objectives are appropriate subject to the previous comments made about disclosure of information.

A number objectives listed as regulatory objectives do not appear to be appropriate objectives of a pensions regulator and fall more into public policy objectives. These are:

- To give those saving for retirement enough information to assess the adequacy of their pension provision
- To ensure that tax reliefs available for pensions are used to provide appropriate pension benefits and are not abused
- To provide pension savers (or trustees on their behalf) with enough information to decide whether or not to use that vehicle for retirement saving, particularly in respect of value for money

While these are laudable objectives it is questionable as to whether they are issues that a pensions regulator should be concerned with.

▪ **Is the level of regulation appropriate to the regulatory objectives we are trying to achieve?**

IAPF Response

In the detail of the implementation of the regulatory objectives, there may be questions to answer. Obviously the pensions regulator should define its key concerns and regulate those. The regulatory objectives that are listed that are really policy objectives should not inhibit the work of the regulator. Ireland is somewhat unusual in having a pensions regulator that is also a pensions policy adviser to the Government. There is a danger that these roles can become blurred and it is important to ensure that they are kept apart. This is particularly so in how the roles are funded as the regulated community currently pays for the operation of the regulator but it would be wholly inappropriate for it to be paying for public policy work.

It should also be remembered that the more people that have pension provision, the better it is for society in general. This is underlined by the efforts made by the Pensions Board and the Government to raise pensions awareness and general government policies throughout Europe to lessen the cost borne by the State and encourage private provision. Furthermore, the vast majority of members of pension schemes in Ireland are members of schemes operated by trustees and set up by employers, often in negotiation with trade unions, on a voluntary basis. These schemes exist for only one reason, to provide pensions for the members of the scheme.

They do not make profits. Therefore, the type of regulation that applies to such schemes needs to reflect this and should be different to the type of regulation that applies to commercial organisations that exist to make a profit.

There is a danger that costly or excessive regulation or the perception of excessive regulation could lead to employers ceasing to continue to provide schemes and/or new employers being disinclined to commence schemes. This is clearly not in the public interest.

In particular, there are extremely detailed Disclosure Regulations in place. There is no obvious reason why the disclosure provisions of the legislation should not become principles based where the principles are set out in the legislation and where necessary these are backed up by guidance from the regulator but trustees do not have to concern themselves with how they word things and can concentrate on how they can best communicate with their members.

There also currently exists a disparity in the level of regulation applied to pension schemes that operate in the private sector and those that operate in the public sector. As public sector schemes are unfunded they are obviously excluded from the operation of the funding standard. There is no obvious reason however why they are excluded from many of the other provisions of the Pensions Act. In particular, to exempt such schemes from requirements such as paying correct benefits when due and ensuring proper records are kept is completely inconsistent with the regulatory objectives outlined. Furthermore, the administration of such schemes is consistently criticised by the Pensions Ombudsman in his annual reports.

All defined benefit schemes must now automatically issue their members with annual benefit statements. There is a cost to this and, particularly with modern working practices, it can be difficult to provide accurate information where people have gaps in service or work part-time hours. Public sector schemes have a specific provision in legislation where they provide access to an on-line calculator and individual members must input their own information. This is not an option available to private sector schemes which must provide individualised information. This may be a contributing factor to the continuing decline in membership of defined benefit schemes in the private sector. There is no obvious reason for these differing approaches and this is something the Pensions Board as a regulator should be urgently addressing.

4. Are there measures that could be taken to introduce transparency in relation to pension fund charges?

IAPF Response

Clearly there are many measures that can be taken to improve transparency in this area. Firstly, it would be important to set out what such measures would be attempting to achieve. For example, the level of charges on defined benefit schemes is largely unconnected to the benefits received by the individual. Therefore charges really only impact benefits on defined contribution arrangements. As it states in the Green Paper, individual contracts are typically more expensive to deliver and service than group occupational pension schemes. Group occupational pension schemes are put in place by employers and trustees and it is not clear if the need to introduce transparency would be for their benefit or for the individual members. However, members do not have a choice in relation to the charges, unless they have the option to opt out of the scheme in which case they would most likely lose the employer contribution. That said, greater transparency may lead to changed behaviour which could be beneficial, assuming that is the intention. Clearly it is an issue for individual contracts where the individuals do have a choice.

Summary

Regulation of pension funds needs to have proper regard to that which is being regulated. It needs to be cognisant of the fact that the entities being regulated are non-profit and exist to provide benefits that are for the social good. While it is in everybody's interest to ensure that standards are raised this must be done in a proportionate manner and the focus should be on those who need regulation and less so on those who don't. Once the objectives of regulation are defined they need to apply to all schemes and there should be no difference between the approach taken on public sector and private sector schemes except where one is appropriate (such as the operation of the funding standard). All regulation has a cost and that cost needs to be borne in mind considering that, for the most extent, pension provision in Ireland operates on a voluntary basis, is for the social good and regulation has the potential to destroy what it is trying to protect.

Chapter 13: Public Sector Pensions

Questions for consideration

1. How should the cost of funding public service pensions be met?
2. Which individual reform options offer the most realistic potential?

IAPF Response

The cost of funding public service pensions should be viewed in the same way as funding private sector pensions, and should therefore be seen as an employment cost appropriately shared between the employer and the members of the scheme. Preferably, the liabilities should be pre-funded as much as possible either through a specially designated fund or the National Pensions Reserve Fund. There should be regular valuations of the liabilities. These should be disclosed through the C & AG's office or some other independent body.

It is imperative that this is done as the costs are increasing greatly and this will ultimately affect taxpayers who provide the only source of funding of public sector schemes. The Minister for Finance recently informed the Dáil that the accrued liability for public sector pensions was €75 billion. This is almost as much as all of the assets of private sector schemes which amounted to €87 billion at the end of 2007. Using the figures in the most recent benchmarking report we have estimated that the employer contribution in respect of public sector employees in 2006 was (if the scheme were funded) approximately €2.6 billion. In addition, in 2006, the State paid out almost €1.6 billion in pensions to retired public servants. The State contributed €1.7 billion to the National Pensions Reserve fund in 2007 and the value of the fund at 31/3/2008 was €19.3 billion. The NPRF was set up to provide for some of the projected increase in costs of public service and Social Welfare pensions. As the cost of these has risen dramatically since the NPRF was put in place an increase in the contributions to the NPRF should be considered.

The matter of which individual reform options offers the most realistic potential is an issue for the employer and employee representatives.

Chapter 14: Work Flexibility in Older Age – A new approach to Retirement

Questions for consideration

1. **Should measures be put in place to encourage later retirement? Should measures be put in place to encourage employers to retain older workers? What form should such measures take?**
2. **Should a system allowing for voluntary deferral of the Social Welfare pension be introduced? How should this operate?**
3. **Should other incentives be introduced to encourage people to work beyond normal retirement age?**
4. **In order to encourage later retirement, should employers be prohibited from setting a retirement age below a certain age? Should they be prohibited from setting any retirement age?**
5. **In order to contain costs and reflect increased life expectancy, should a change be made to the retirement age for Social Welfare pensions? How should such a change be implemented?**

IAPF Response

We believe there should be measures in place that encourage and facilitate those who wish to work longer. It may be necessary to try and move away from the concept of retirement as a point in time event and view retirement as something into which people can gradually transition. This involves much more than changing rules and legislation as it is primarily a change in attitudes and approach to that part of our lives that is required. Indeed it could be argued that this change is happening to some extent already but that the rules and legislation around retirement have not caught up and are hindering this.

There are many barriers that currently exist that discourage the possibility of phased or later retirement and these must also be removed in order to allow people who so desire, to avail of this option. One of the main obstacles to later retirement is current system of having a State Pension (Transition) payable from age 65 and the State Pension (Contributory) from age 66. Effectively the State Pension (Transition) is only payable if an individual is not working and this puts a lot of pressure on individuals to cease working as they see it as losing something to which they are entitled. Furthermore the fact that employers and pension schemes more often than not have a set retirement age of 65 and the combination of this and the State Pension (Transition) lead people to assume they must retire at that age and there are many practical and financial reasons why they should.

The fact that the total contributions being paid for many members of defined contribution schemes are not sufficient to produce an adequate income at the age those members expect to retire will lead to a greater need for people to work longer. It has been estimated that a 25 year old entering the workforce with average contribution rates could need to continue to work and make contributions on a full-time basis until age 75 in order to accumulate a fund sufficient to secure a pension of 50% of salary. In the future we need to be able to cater for situations such as this and allowing partial drawdown of benefits is one way that would allow individuals to transition to retirement. Indeed our policy of allowing members of DC schemes to transfer benefits to Approved Retirement Funds would also enhance an individual's ability to phase retirement and partially draw on funds where necessary.

Thus there needs to be a change in many of the employment, pensions, tax and social welfare rules in order to facilitate a culture of working past the traditional retirement age for those who wish and are able to do so. This would ensure that those people are not disadvantaged in any way.

There should be a system allowing for voluntary deferral or partial drawdown of the Social Welfare pension. It could be introduced on the basis of people being able to defer their State pension until age 70 and when they do decide to commence they have a choice of an increased pension or a lump sum based on the actuarial value of the pension deferred. During the period of deferment individuals should be able to continue to work and pay PRSI. Alternatively individuals could take part of their Social Welfare pension while continuing to work.

It is difficult to see a basis for introducing a workable ban on employers setting retirement ages below certain ages. While there is no particular logic in setting a fixed age whereby people are deemed no longer suitable for work, there are also many jobs where it is not possible or desirable for people to work beyond certain ages. It would be more appropriate and productive to develop and encourage greater flexibility in individual's, employer's and the State's approaches to retirement.

The demographic projections would suggest that there needs to be much more flexibility around retirement due to the large decrease in the real pensioner support ratio (number of workers to those over age 65, from 4.2 to 1.5 by 2052). These also raise questions relating to the wider economy and productivity. The State needs to ensure that any commitments in relation to State Pensions are sustainable.

APPENDIX 1



lifestrategies
ACTUARIAL & STRATEGIC CONSULTING

An analysis of certain tax aspects of the Irish system of pension provision

A research report for the Irish Association of Pension Funds

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May 2008

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1 Introduction & background

1.1 Introduction

This report presents an analysis by Life Strategies of certain aspects of the Irish system of pension provision, principally relating to the issue of tax reliefs for supplementary pension provision.

It has been prepared in response to a request from the Irish Association of Pension Funds (“IAPF”) for research on this subject.

1.2 Background to the request for research

Following the publication of the Green Paper¹, the IAPF wished to address the view that has been put forward in certain quarters to the effect that it would be desirable to divert the cost of the tax reliefs granted in respect of the current voluntary supplementary pensions system (“Pillar 2”) to the State (“Pillar 1”) system instead, thereby allowing a substantial increase in the level of the Pillar 1 pension.

The IAPF had concerns that this analysis was overly simplistic and failed to address a number of important issues, including:

- that the cost of the tax relief is difficult to estimate precisely and may be subject to significant variability from year to year;
- that the cost of the tax relief may not be readily transferable to the Pillar 1 system;
- that the “cost” of the tax relief is really tax deferred rather than tax foregone, and that any analysis needs to recognise and quantify this point;
- that the argument for an increase in the level of the Pillar 1 pension cannot be made solely on the basis of the current cost: one also needs to look at the longer-term implications.

Following a tender process, the IAPF engaged Life Strategies to conduct a research assignment to provide a quantitative and qualitative analysis of these issues.

1.3 Structure of the report

The remainder of this report is structured as follows:

- The following pages provide an Executive Summary of the report.
- Chapter 3 examines the tax reliefs granted to incentivise supplementary pension provision and the estimate of the current cost of those reliefs.
- In Chapter 4 we analyse the cost implications of diverting the resources currently employed in incentivising supplementary pension provision to provide an increased State Pension instead.
- In Chapter 5 we look at the implications of tax deferral to examine the true cost of tax reliefs.

¹ Department of Social and Family Affairs (2007), *Green Paper on Pensions*
Available at: <http://www.pensionsgreenpaper.ie/downloads/GreenPaper.pdf>

2 Executive Summary

2.1 Estimate of cost of tax reliefs

In Chapter 3 we examine the published estimate for the cost of tax (and other) reliefs for private pension provision and also consider how much of this cost could be saved and diverted to fund an increase in the State Pension.

The Green Paper places an estimate of €2.9 billion on the annual cost of tax (and other) reliefs for private pension provision, made up of €1.9 billion in respect of reliefs on contributions, €1.2 billion in respect of the tax foregone by exempting the investment earnings of pension funds from tax and €0.1 billion in tax-free lump sum payments on retirement, less €0.3 billion in tax revenues from pensions in payment.

We would broadly concur with the estimate of €1.9 billion for the cost of reliefs on contributions, but we would argue that the €1.2 billion estimate of tax foregone on the investment earnings of pension funds is overstated. Our calculations, based on more realistic assumptions for achievable investment returns, give an estimate of which is more than €300 million lower.

We also take issue with the approach to allowing for the offsetting effect of the tax revenues which are generated by pensions in payment. The Green Paper simply deducts an estimate of the current year revenues from an estimate of the current year costs. However, this does not compare like with like – the costs are a function of the size of the current pre-retirement population whereas the tax revenues are a function of the retired population in receipt of private pensions. Given current Irish demographics and given the relative immaturity of the Irish private pension system, the former is much larger than the latter. Simply comparing current costs with current revenues is not an appropriate methodology. We return to the question of appropriately measuring the impact of tax deferral in Chapter 5.

We note that diverting the full cost of existing reliefs would involve abolishing tax reliefs on pension contributions and imposing tax on pension funds' investment earnings, which would move the Irish system from its current "EET"² design to a "TTE" model. We question the thrust of any such proposal, noting that none of the other "old" EU Member States operates a TTE system and indeed the EU Commission has advocated the EET model as the most desirable one.

We also challenge the assumption that the full cost of the existing reliefs would be available to the Exchequer to deploy elsewhere in the event of the abolition of those reliefs. We note that private pension contributions could be expected to reduce (perhaps considerably) in that event. We also note that the tax revenues from taxing funds' investment earnings could be expected to be quite volatile from year to year. In our view an estimate of €2.0 billion (rather than the €3.1 billion in the Green Paper) is a more realistic estimate of the additional tax revenues which would accrue to the Exchequer in the event of the abolition of reliefs on contributions and the imposition of tax on investment returns.

Finally in Chapter 3, we point out that the estimate of the cost of tax reliefs set out in the Green Paper focuses solely on private sector pension arrangements and does not

² EET stands for Exempt contributions, Exempt fund growth and Taxable benefits.

include any allowance for public sector pensions. We estimate the total employer and employee contributions to public sector pensions as being in excess of €3 billion per annum and point out that, in the interests of equity, any move to abolish tax relief on employee contributions and/or to remove the BIK exemption from employer contributions would need to apply to both private and public sector arrangements.

2.2 Cost of diverting tax reliefs to increase State pensions

The argument has been made that it would be a better use of the State's resources if the tax reliefs which are currently granted to private pensions were removed or significantly curtailed, with the resulting savings being used to increase the level of the State Pension on a cost-neutral basis.

In Chapter 4 we examine this proposition, focusing on what we see as the fundamental flaw in this argument, which is that any proposed increase in the level of the State Pension needs to be properly examined in terms of its long-term sustainability: one cannot and should not simply look at the current year cost but also at the long-term implications. An increase to the State Pension may be cost neutral in the current year but will give rise to a substantial increase in costs as the demographics shift.

We first point out that the cost of the State Pension is projected to increase very considerably in the coming decades even before any increase in the level of pension is contemplated. Projections indicate that the annual spend is set to increase from its current level of roughly 3% of GNP to in excess of 10% of GNP by the middle of the century. On the other hand, projections indicate that the net cost to the Exchequer of supporting the supplementary pension system through tax reliefs will remain stable at close to its current level.

Spending an additional €2 billion on State Pensions in the current year would permit an increase in the level of the State Pension from its current level of 34% of average earnings to 50% of average earnings at no additional current year cost to the Exchequer (on the assumption, outlined above, that €2 billion is a reasonable estimate of the savings which would accrue by abolishing reliefs on contributions and taxing investment returns).

However, projections show that this strategy, although cost-neutral in the current year, would result in a substantial worsening of the overall budgetary position as the population ages. In summary it would result in a net additional cost of over 2% of GNP by the middle of the century, thus exacerbating the sustainability issues which are clearly set out in Chapter 3 of the Green Paper.

2.3 Impact of tax deferral on true cost of tax reliefs

In Chapter 5 we note that any analysis of the cost of tax incentives to encourage private pension provision needs to allow for the fact that, in many cases, those incentives will result in additional tax revenues in future years. Thus the question is one of tax deferred rather than tax completely foregone.

We explore this concept by calculating the "net effective rate" of tax relief on pension contributions and comparing it to the "headline" rate.

The headline rate of relief is simply the amount of tax and PRSI relief expressed as a percentage of the pension contribution. It shows the cost of the reliefs granted but makes no allowance for the tax revenues which will accrue in the future as a result of

having granted those reliefs. In contrast, the net effective rate of relief makes allowance for those future tax revenues by netting them off against the cost, allowing for the time value of money.

The results are interesting: we find that for high earners the net effective rate of relief is lower than the headline rate (reflecting the fact that tax will be paid on the pension in retirement) and that the net effective rate of relief falls as you move up the income band. Those who do best, in terms of having the highest net effective rate of relief are those whose earnings just exceed the standard rate cut-off point.

Another point which emerges from this analysis is that, for any given level of earnings, the net effective rate falls as the contribution rate increases. This is a little-remarked but desirable feature of the current system.

In summary, therefore, we find that the current system gives the highest benefit to those earning just above the average industrial wage and that the benefit falls as one moves up the earnings scale and/or as one increases the level of pension contributions.

3 Tax reliefs for pension provision

3.1 Nature of tax reliefs granted to Pillar 2 pensions

As described in Chapter 7 of the Green Paper, *“the State encourages individuals to supplement the Social Welfare pension with private pension arrangements by offering tax reliefs on private pension provision”*.

The Green Paper summarises these incentives as follows:

“Tax relief takes the form of relief on amounts contributed to the pension schemes and on the amount of profits and gains generated by the investments held by the schemes. Benefits payable on or after retirement are taxable subject to an entitlement to take a tax-free lump-sum cash benefit. Contributions to pension investments are tax [and PRSI] relieved on the way in (subject to limits) and are allowed to grow tax free in the pension fund in the expectation that the pension benefit stream will be taxed on the way out. These tax arrangements are known as the EET system of pension taxation, i.e. exempt contribution, exempt fund growth and taxable benefits.”

More details on the precise nature and limits of the tax treatment of the various forms of supplementary pensions provision (occupational schemes, RACs, PRSAs) are provided in paragraphs 7.10 to 7.25 of the Green Paper.

3.2 Green Paper estimate of current cost

The estimated cost of tax and PRSI reliefs for private pension provision is set out in paragraphs 7.30 to 7.35 and Appendix C of the Green Paper.

The estimate, which was arrived at by an *“informal working group made up of officials of the Department of Finance, the Revenue Commissioners, the Department of Social and Family affairs and the Pensions Board”*, is set out in Table 7.2 of the Green Paper as follows:

	Estimated costs €million
Employees' Contributions to approved Superannuation Schemes	540 ^a
Employers' Contributions to approved Superannuation Schemes	120 ^b
Estimated cost of exemption of employers' contributions from employee BIK	510 ^c
Exemption of investment income and gains of approved Superannuation Funds	1,200 ^d
Retirement Annuity Contracts (RACs)	380 ^e
Personal Retirement Savings Accounts (PRSAs)	120 ^f
Estimated cost of tax relief on “tax-free” lump sum payments	130 ^g
Estimated cost of PRSI and Health Levy relief on employee and employer contributions	220 ^h
Gross cost of tax relief	3,220
Estimated tax yield from payment of pension benefits	320 ^j
Net cost of tax relief	2,900

See Appendix C for footnotes to table 7.2

More detail on the calculation of the individual line items is set out in Appendix C of the Green Paper.

3.3 Comments on the Green Paper estimate

We had previously calculated our own estimate of the cost of tax and PRSI reliefs for private pension provision in a report for the Pensions Board³.

The figures from our NPR report for the cost of tax and PRSI reliefs on contributions can be compared with the total of items (a) to (c), (e) to (f) and (h) in the table above. In summary, we calculated costs of €1,413 million in 2006⁴ as opposed to costs of €1,890 million above. The difference can be explained by the fact that the workings in our NPR report did not allow for the cost of the exemption of employers' contributions from employee Benefit-In-Kind ("BIK"). Adjusting for this, the two estimates line up remarkably well (€1,413 million versus €1,380 million) considering that they have been derived quite independently and using quite different methodologies.

One relatively small point of contention is that we would question the logic of including both the cost of tax relief on employers' contributions (where relief at 12.5% is assumed on the basis that such contributions are a deductible expense for corporation tax purposes) and also the cost of the employee BIK foregone on those contributions.

It seems to us that there is an element of double counting here: if one wants to count the latter then one should not count the former. We take this view on the basis that, instead of making an employer pension contribution, an employer has the option to pay his employees an additional amount in salary (or other benefits) instead. Any such additional salary payment would also attract corporation tax relief at 12.5% and the employee would pay tax on that additional pay (at the employee's marginal rate) unless the employee paid the amount into the pension scheme as an employee contribution (in which case it would attract tax relief at the employee's marginal rate). The point is that the corporation tax relief at 12.5% would apply either way – whether the employer makes the payment as a pension contribution or as salary – so it seems illogical to us to include this as a specific pension-related relief.

Overall, however, given that this relief contributes only a relatively small amount to the overall total (€120 million out of a total of €1,890 million) we are broadly happy that the estimate of tax and PRSI reliefs on contributions is a reasonable one⁵.

Although we are broadly happy with the estimate for the cost of reliefs on contributions, there are three other aspects of the Green Paper's overall estimate of total reliefs (€2,900 million) with which we have serious reservations.

Desirability of moving away from an EET system

Firstly we take issue with the implication from this costing that one could reasonably both abolish tax reliefs on contributions and impose a tax on the income & gains of pension funds. Assuming that, in return for such changes, pension benefits would then be exempt from tax (which is not certain), this would move the Irish system to a TTE system which would be unique within Europe.

³ The report in question was entitled "*Alternative systems of pension provision: An assessment for the Pensions Board*" and was published as Appendix 6 to the Pensions Board's report on the National Pensions Review. It is available at: http://www.pensionsboard.ie/getFile.asp?FC_ID=302&docID=295

We refer to it as "our NPR report" throughout the remainder of this report.

⁴ See Table 7.7 of our NPR report.

⁵ It should be noted that this estimate does not include the cost of reliefs in respect of public sector schemes. See section **Error! Reference source not found.** for more details on the estimated cost of public sector reliefs.

According to a European Commission report⁶, the majority of European Union member states operate on an EET basis (i.e. the same approach as currently in place in Ireland):

“... the large majority of Member States have what is described as the EET system (Exempt contributions, Exempt investment income and capital gains of the pension institution, Taxed benefits). Three Member States have the ETT system (Exempt contributions, Taxed investment income and capital gains of the IORP, Taxed benefits), while two Member States operate a TEE system.”

As can be seen from the following table, at the time of the Commission’s report, 11 out of the then 15 Member States operated an EET system, 3 operated an ETT system and 2 operated a TEE system⁷.

Country	EET	ETT	TEE
Belgium	X		
Denmark		X	
Germany	X		X
Greece	X		
Spain	X		
France	X		
Italy		X	
Ireland	X		
Luxembourg			X
Netherlands	X		
Austria	X		
Portugal	X		
Finland	X		
Sweden		X	
United Kingdom	X		

Source: European Commission (2001)

As can be seen from the table, none of the countries operated the TTE system which would result from fully abolishing tax reliefs on contributions and imposing a tax on investment income (which is the implication of counting the full cost of these reliefs as a cost).

On the contrary, rather than moving away from an EET system, the Commission advocates that those countries which do not already operate on an EET basis should consider adapting their pension systems to move to that approach:

“Eleven Member States have an EET system, three have an ETT system, and two have a TEE system. This means that in practical terms it is probably easiest to strive for alignment of Member States’ pension taxation systems on the basis of the EET principle. Moreover, by providing for a tax deferral on the contributions paid, the EET system

⁶ European Commission (2001), *The elimination of tax obstacles to the cross-border provision of occupational pensions*, COM(2001) 214.

⁷ The figures sum to 16 rather than 15 as, at the time, the German Pillar 2 system had both EET and TEE pension arrangements. Germany has since moved more towards an EET basis.

encourages the making of retirement provision. The EET system also helps to cope with demographic ageing as it reduces tax revenues today in exchange for higher tax revenues at the time when the demographic dependency ratio will be much more unfavourable.”

“... The Commission does not therefore envisage proposing legislative measures to harmonise Member States’ pension taxation systems. Nevertheless, as alignment of Member States’ systems according to the EET principle would help to reduce the mismatches which lead both to double taxation [and] non-taxation, the Commission would welcome its broader acceptance.”

This is also referred to in the Green Paper where it states:

“7.3 ...Fourteen out of the fifteen “old” EU Member States operate either an EET system or ETT system (exempt contribution, taxed fund growth and taxable benefits) and the EET approach is the preferred system from the point of view of the European Commission.”

Estimate of tax foregone on pension funds’ investment income & gains

Secondly, we would take issue with the estimate in the Green Paper of the tax “foregone” by exempting the investment income and gains of pension funds’ assets. According to Note (d) in Appendix C of the Green Paper, the estimate of €1,200 million was calculated as follows:

“The estimated average value of pension fund assets under management in Ireland in 2006 is estimated at €80 billion. The estimated long-run rate of return for the purpose of the tax cost is assumed to be 7.5% at an assumed tax rate of 20%.”

This crude estimate can be challenged on a number of fronts.

Firstly, the calculation assumes a long-term nominal rate of return of 7.5% per annum (after charges). This assumption, which seems to have been arbitrarily picked with no explanation, seems to us to be a very high assumption in the current relatively low-inflation environment.

By way of comparison, in our projections in our NPR report we assumed real investment returns of 5.35% on equities and 1.65% on government bonds (see section 6.8.3 of our NPR report for more details). Based on an assumption of a long-term average 60:40 equity/bond asset mix in defined benefit pension funds (and allowing for some investment in higher-yielding corporate bonds within the bond portfolio), these rates gave us an assumed real investment return for defined benefit schemes of 3.9% p.a. (before allowing for charges for investment management). Allowing for the effect of “life-styling” in defined contribution funds (whereby members’ assets are gradually shifted out of equities and into bonds as they approach retirement), our modelling indicated that a lower investment return assumption (3.6% p.a.) was appropriate for defined contribution arrangements.

If take the average of these two rates we get an assumed real rate of return of 3.75% p.a. Adding the long-term ECB inflation target of 2.00% p.a. gives an implied nominal return of 5.75% p.a. rather than the 7.5% p.a. used in the Green Paper estimate.

Using an assumption of 5.75% rather than 7.5% would reduce the estimate of the tax foregone by not taxing the investment income & gains of pension funds from €1,200 million to €920 million, thereby reducing the overall cost estimate by almost €300 million.

Finally, it is arguable that even 5.75% is overly optimistic given (a) the greater trend towards bond investments as a result of the imposition of funding standards and accounting standards and (b) the fact that it makes no allowance for the costs of investment management.

If, rather than assuming a 60/40 equity/bond mix, we assume a 40/60 mix instead and if we allow for a 0.20% p.a. reduction in returns due to the cost of investment management, we would end up with a 5.4% p.a. assumption for net investment returns. Using this assumption would put the estimated cost of tax foregone on investment income & gains at €864 million (rather than the €1,200 million estimate in the Green Paper).

Secondly, the estimate makes no reference to the inherent volatility of the rate of return earned on pension fund assets from one year to the next. Average pension managed fund annual returns have varied from minus to 20% to plus 20% over the period since 2000, with negative returns in three of the years (and returns are likely to be negative again in 2008). This also begs the question of what would happen if a pension fund has an investment loss in a particular year: would this give rise to a tax credit in subsequent years?

Thirdly, the estimate of the cost of not taxing pension fund investment returns makes no offsetting allowance for the fact that exempting income and gains from tax leads to higher fund values and hence higher ultimate pensions than would otherwise be the case (leading to higher tax revenues from those pensions).

Finally, is it really correct to consider this as tax foregone? This point is made by the Pensions Board in the National Pensions Review report:

“6.6 Most assessments of the cost of support for supplementary systems include an estimate of the tax foregone on pension assets’ investment income. However, it could be argued that this is not necessarily appropriate. There is a tax cost only if the investments would have been made in any case, whether or not there were incentives.”

This is a somewhat philosophical argument but one which has some merit. In practical terms, it can be re-stated in a different form which is “Is it appropriate to tax investment returns when the investments were made on the basis that they would not be taxed?”

Credit for tax revenues from taxing pensions

The third serious flaw in the overall Green Paper cost estimate is the way in which credit is taken for the tax revenues which are received from taxing pension income. To use the common phrase, the approach adopted in the Green Paper “compares apples and oranges”.

Indeed the Pensions Board made this point in the National Pensions Review:

“6.7 ... the amount of tax relief granted in each year for supplementary pensions does not make allowance for the future income tax payable on those pensions. Also, of course, the size, age profile and income level of the two groups are different and are constantly changing.”

As the Irish supplementary pension system is still a very immature system with far more active contributors than retired pensioners, the level of pensions in payment is currently very low. Any proper analysis of the net cost of the current system needs to look at the

evolution of the cost as the system matures. We return to this point in our analysis in Chapter 4 and Chapter 5.

3.4 The transferability of tax reliefs

The Green Paper makes the point that one needs to be very careful in drawing any conclusions from the costing of tax on other reliefs, on the basis that the removal of such reliefs would have significant economic and behavioural impacts:

“7.34 The information imparted by the costing of tax and other reliefs in the pensions area as detailed above is, however, inherently limited. It may suggest a significant notional loss against an equally significant assumed yield in the counterfactual situation of tax reliefs for supplementary pension provision not being available. However, where tax relief arrangements are of such significance, as in this instance, the removal of the reliefs would represent a fundamental adjustment to the current balance of the tax system and would have very significant implications in terms, among other things, of the economic and behavioural impacts which would ensue. These impacts would be difficult to model in advance. For these reasons, the real informational content of these costings of tax reliefs is limited and should be treated with some caution.”

On the face of it, abolishing tax relief on contributions could be expected to yield extra tax revenues of the amount set out in Table 7.2 in the Green Paper (i.e. approximately €1.9 billion). However, it could reasonably be expected that, in the event of abolishing relief, current contributors to pension schemes would look for other more tax-efficient savings options. Even if we assume that only the self-employed would seek out such alternatives (as they have the most flexibility to change their pension arrangements), we could tentatively estimate that perhaps one-third or more of this amount would not in fact materialise.

Taxing the investment returns of pension funds might be expected to yield more predictable tax revenues as the assets within pension funds are, to a large extent, “trapped” and could not easily be moved to avoid such tax. Of course, there would be considerable anger at the imposition of such a tax as employers and employees put aside monies in pension funds on the understanding that they would grow tax-free and are not now in a position to avoid this tax. This could make it a politically unacceptable move. In addition, given that public sector schemes are (by and large) operated on an unfunded basis, any move to tax funded schemes would bear disproportionately on private sector schemes.

As already noted above, the other important point in relation to the tax yield from taxing pension funds’ investment income & gains is that it can be expected to be very volatile from year to year, making budgeting and forecasting very difficult.

In summary, on the basis of our assumption above that perhaps one-third or more of the tax reliefs on contributions would not transfer, and using our estimate of tax foregone by not taxing investment returns, we estimate that €2.0 billion⁸ is a more credible estimate of the additional tax revenues which would accrue to the Exchequer in the event of the abolition of reliefs on contributions and the imposition of a 20% tax on investment returns.

⁸ Taking 66% of €1,770 million for contributions and adding €864 million of tax on investment income gives a figure of €2,032 million. €1,770 million is derived by taking the total of €1,890 million referred to in section 3.3 above and removing the €120 million in respect of corporation tax relief on employer contributions (for the reasons set out in that section). The figure of €864 million is also derived in section 3.3 above.

3.5 Public service pensions

Finally, it should be noted that the figures quoted in Chapter 7 and Appendix C of the Green Paper for the cost of reliefs on employer and employee contributions focus solely on private sector schemes and do not include contributions to public sector schemes.

We estimate that the (notional) employer contributions to public sector schemes amount to some €2.7 billion. The detailed derivation of this figure is set out in Appendix E, but in short it involves applying the contribution rates that were reported in the most recent Benchmarking Report (2007) to the public sector pay bill. In addition, information published by the Department of Finance (2006) on the public sector pay and pensions bill for that year indicates that the employee contributions to public sector schemes amounted to €387 million⁹.

Applying the same approach as set out in the Green Paper to determining the cost of tax relief and BIK exemptions on public sector pension contributions gives an additional cost of almost €1.2 billion¹⁰.

For consistency with the figures in the Green Paper, this additional €1.2 billion has not been included in the estimate of the resources which would be available in the event that tax reliefs were abolished. However, in order to ensure equitable treatment of private and public sector scheme members, any move to reduce or remove tax reliefs on private sector arrangements would also need to be mirrored in the public sector.

⁹ In fact, the figure of €387 million only covers the "Civil Service, Health, Education, Guards and Army" and so the total cost (including local government and non-commercial State bodies) will be somewhat higher.

¹⁰ Applying the assumed marginal rate of 38% to the total (notional) employer contributions of €2,720 million and the employee contributions of €387 million gives a cost of €1,181 million.

4 Diverting tax reliefs to Pillar 1

4.1 Introduction

The argument has been advanced in certain quarters that it would be a better use of the State's resources if the tax reliefs which are currently granted to private pensions were removed or significantly curtailed, with the resulting "savings" being used to increase the level of the State Pension on a cost-neutral basis.

In this chapter we examine this proposition, focusing on what we see as the fundamental flaw in this argument, which is that any proposed increase in the level of the State Pension needs to be properly examined in terms of its long-term sustainability: one cannot and should not simply look at the current cost but also at the long-term implications.

4.2 Modelling projected future Exchequer costs

4.2.1 Methodology and assumptions

We have examined the financial implications of diverting tax reliefs to the Pillar 1 system using a methodology and assumptions which are, as far as possible, based on and consistent with the methodology and assumptions that we have used in our NPR report.

In broad terms, the approach we took in our work for the National Pensions Review to assess the future cost (and hence sustainability) of the existing pension system, was as follows:

- We first produced demographic & economic projections which formed the basis for our projections of the economy, population and labour force.
- Having gathered the relevant data, we analysed and modelled the features of the pension systems in order to project the net cost to the Exchequer of each system.
- In doing we looked at the three components of the pension system:
 - The State Pension ("Pillar 1")
 - Public service pensions
 - Private sector pensions

For Pillar 1 and public service pensions we based our projections on work undertaken by the Department of Social and Family Affairs and the Department of Finance respectively to ensure harmonisation and consistency between the approaches taken in respect of each component.

- We then aggregated the results for each component to provide a picture of the overall net cost to the Exchequer, allowing for the funding from Social Insurance contributions and the National Pensions Reserve Fund.

Using these projections we were then able to comment about the sustainability of both the current and any proposed alternative system.

Clearly, when projecting the future development of any pensions system over a 50 year period, a great many assumptions are required. Chapters 5, 6 and 7 of our NPR report

provide a full description of the methodology and assumptions used. They are also summarised for convenience in Appendix A of this report.

These assumptions fall under the following main headings:

- Demographic assumptions
- Economic assumptions
- Labour force & earnings assumptions
- Pension system assumptions

The projections also required a number of assumptions to be made about the future development of the current pension system. Two key assumptions are:

- That the Pillar 1 pension increases each year in line with earnings inflation.
- That overall private sector Pillar 2 coverage rates remain constant at their current levels. New entrants to defined benefit schemes are assumed to dry up over the next 20 years (with occupational defined contribution and personal arrangements making up the difference).

For maximum comparability with the costings in the Green Paper and other recent reports, we focus on the results from our NPR work.

4.2.2 Financial projections

On the basis of the methodology and assumptions outlined above, we projected the total gross and net Exchequer costs of pensions over the period to 2056.

Projected gross spend on public pensions

Looking first at the projected level of spending on public pensions, we found a projected increase in pension costs of almost 10 percentage points, from 4.3% of GNP in 2006 to 13.8% in 2056. As can be seen from Table 4.1, the bulk of this increase relates to the State Pension (“Pillar 1”). It must be remembered that these projections are on an “as is” basis i.e. no benefit improvements (other than up-rating in line with earnings) have been assumed. More detail on our methodology and assumptions is provided in Appendix B of this report.

Table 4.1: Projected public pension spending to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
Public service pensions	1.3%	2.1%	2.8%	3.3%	3.6%	3.7%
Total public pension spend	4.3%	5.8%	7.7%	9.8%	12.3%	13.8%

Source: Our NPR report

It is interesting to note that other recent studies have reached similar conclusions. Three studies, conducted independently and using different methodology and assumptions, all reached very similar conclusions regarding the projected increase in public spending on pensions over the coming decades.

Table 4.2: Projected public pension spending to 2056 as a % of GNP – various studies

	2006	2016	2026	2036	2046	2056
Our projections (NPR)	4.3%	5.8%	7.7%	9.8%	12.3%	13.8%
Department of Finance	n/a	7.4%	9.1%	11.1%	14.2%	n/a
EPC & EU Commission	5.8%	7.3%	8.8%	10.4%	12.6%	n/a

Source: Pensions Green Paper, page 26.

Indeed, on the face of it, our projections are at the optimistic end compared to the other two.

In addition, the most recent Actuarial Review of the Social Insurance Fund¹¹, produced very similar projections for the cost of State Pensions to those in our NPR report¹².

From this, we can reasonably conclude that our methodology and assumptions are robust, credible and consistent with those used by other recent forecasters in this area.

Projected cost of tax reliefs on private pensions

Our NPR report was the only report which also investigated the projected cost to the Exchequer of the private pension system.

In order to do this we needed to gather a lot of data on the current state of the Pillar 2 system and to make certain assumptions about its future development. Section 7.7 of our NPR report provides considerable detail on our methodology and assumptions and these are also summarised in Appendix C of this report for convenience.

We were pleased to be able to provide projections for this important aspect of the overall Irish pensions system for inclusion in the National Pensions Review as, to the best of our knowledge, this had never been attempted previously¹³. Our projections in this regard compared the projected annual cost of tax and other reliefs on contributions and the tax foregone by not taxing pension fund investment income & gains (at 20%) with the projected tax revenues coming from Pillar 2 pensions being paid to pensioners¹⁴.

Looking at the cost to the Exchequer of the private system, a very interesting picture emerged: in contrast with the cost of Pillar 1 and public service pensions, the net cost of the private sector Pillar 2 system was projected to increase only marginally from its current level before subsequently falling back to below current levels.

¹¹ Mercer Human Resource Consulting (2007), *Actuarial Review of the social Insurance Fund 2005*

¹² Particularly if one compares our figures against the figures produced in the Actuarial Review on the “Lower Migration Assumption” which is comparable to the central migration assumption in our NPR report.

¹³ See, for example, comments to this effect on page 135 of *For Richer, For Poorer* (ed. Stewart, 2005)

¹⁴ The loss of tax revenue from the option to take a tax-free retirement lump sum is included in our projections (as everyone is assumed to take the full tax-free lump sum).

Table 4.3: Private-sector Pillar 2: projected net Exchequer costs to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Reliefs on contributions	1.4%	1.5%	1.5%	1.4%	1.3%	1.3%
Tax foregone on investment inc.	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost of Pillar 2	1.6%	1.8%	1.8%	1.7%	1.4%	1.4%

Source: Our NPR report, with tax relief on contributions adjusted upwards to allow for cost of BIK exemption on employer contributions (which was not allowed for in the costings in our NPR report, as discussed in section 3.3 above).

This trend can be explained as follows:

- Tax relief on contributions is more or less constant as a proportion of GNP (as it is assumed that the proportion of the labour force contributing to private pensions remains at its current level) with a slight reduction over time due to the movement away from defined benefit schemes towards defined contribution schemes (which are assumed to have lower contribution rates).
- The tax foregone on investment income increases for the first three decades before stabilising as pension fund assets stabilise as a proportion of GNP.
- The tax revenue collected from pensions being paid to pensioners of private sector schemes is projected to increase quite considerably from its current levels as the private pension system matures.

Projected total net Exchequer cost of pensions

Bringing together the results of Table 4.1 and Table 4.3, and allowing for PRSI revenues and the National Pensions Reserve Fund (NPRF) as per our NPR report, the projected net cost to the Exchequer is as summarised in Table 4.4.

Table 4.4: Overall projected net Exchequer cost to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
Public service pensions ¹⁵	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Net Pillar 2 cost	1.6%	1.8%	1.8%	1.7%	1.4%	1.4%
Net cost to the Exchequer	2.9%	4.4%	5.9%	6.2%	6.5%	7.2%

Source: See earlier tables. Figures for PRSI revenues and NPRF transfers are taken from our NPR report.

In summary, the overall picture that emerges is that the net cost to the Exchequer of the current pension system is projected to increase very considerably over the period to 2056.

However, what is also clear from the projections is that the main driver of this overall increase is the projected increase in the cost of Pillar 1 and public service pensions:

¹⁵ The figures for the net cost of public service pensions are lower than those in Table 4.1 above as the projected tax revenues from public service pensions in payment have been netted off.

taken together, gross expenditure on these items is projected to increase from 4.3% of GNP to 13.8% of GNP over the period in question (see Table 4.1).

PRSI revenues are stable at 3.7% of GNP (assuming no change from current contribution rates) and the NPRF is projected to defray costs in the later decades of the projection (e.g. contributing 3.5% of GNP p.a. by 2056).

As already highlighted above, the net cost of private sector Pillar 2 pensions (i.e. tax reliefs on contributions and investment returns, less tax revenues from pensions in payment) is projected to remain close to its current level throughout the projection period.

On the basis of these findings, it seems fair to comment that there are serious issues with the sustainability of the current Irish pension system, but that those issues do not stem from the cost of providing tax reliefs to the Pillar 2 system but rather from the increasing cost of the Pillar 1 system.

As noted earlier, our findings in this regard have been backed up by other studies (as summarised in Chapter 3 of the Green Paper). The actuarial review of the Social Insurance Fund calculated that Social Insurance contributions would have to increase by 74% in order to equalise the income and expenditure of the Social Insurance Fund over the next 50 years, assuming that the State Pension continues to be pegged at 34% of gross average industrial earnings (“GAIE”). To put this in context, this would require total Social Insurance contributions to increase immediately from their current level of approximately 11% of labour force earnings to approximately 20% of labour force earnings, just to ensure that the Pillar 1 system can be sustained in its current form.

4.3 Financial implications of diverting all tax reliefs to Pillar 1

Having examined the projected costs of maintaining the current system, we now recalculate the projected costs assuming that the tax reliefs currently granted in respect of private pension provision are abolished and the State Pension is increased instead.

Increase in level of State Pension

It is first necessary to make an assumption about how much the State Pension would increase in this scenario.

According to the Actuarial Review of the Social Insurance Fund, pension¹⁶ benefits of €3.68 billion were projected to be paid from the fund in 2006. In addition, from the information provided in our NPR report¹⁷, we can estimate the additional non-contributory¹⁸ pension expenditure at approximately €850 million, giving a total public pension spend of just over €4.5 billion.

If we accept the Green Paper estimate of the 2006 tax (and other) reliefs for private sector pensions of €2.9 billion and if we accept that all of these costs could be fully diverted into supporting the public pension system, then diverting all of this to the public pension system would allow the 2006 pension bill to rise to €7.4 billion in 2006 at no additional current cost to the Exchequer.

¹⁶ See Appendix E. Includes State Pension (Contributory), State Pension (Transition), Widows/Widowers Pension (Contributory).

¹⁷ See information provided in Table 5.1 of our NPR report.

¹⁸ The State non-contributory pensions are means tested and fall under the heading of social assistance rather than social insurance. They are not paid out of the Social Insurance Fund, therefore.

Given that the current State Pension (Contributory) is set at a level of approximately equivalent to 34% of gross average industrial earnings (“GAIE”), this would imply that the level of the State Pension could be increased to roughly of 55% of GAIE at no additional current cost to the Exchequer.

If we are more realistic in our assessment of tax revenues which could be expected to accrue from the abolition of the reliefs on contributions and the imposition of tax on investment returns (see section 3.4 above) and work on the basis of a 2006 figure of €2.0 billion instead, then the increased level of the State Pension which can be financed by diverting tax reliefs becomes 50% of GAIE.

In the following paragraphs we re-run our financial projection models on the basis of an immediate increase in the State Pension to 50% of GAIE to examine the longer-term impact of this action.

4.3.1 Assumption changes for the proposal to divert tax reliefs to Pillar 1

Of course, diverting Pillar 2 tax reliefs to provide enhanced Pillar 1 benefits can be expected to have an impact on Pillar 2 pension arrangements and would therefore require a revision of the assumptions relevant to those arrangements.

Therefore, in order to model the impact of this proposal, it is necessary to alter some assumptions and to introduce some new ones, as follows:

- Coverage rates: We assumed that there would be no future new entrants to existing schemes, except in the highest income band (as everyone else will automatically have at least a 50% replacement rate thanks to the increase in the State Pension).
- Contributions: For defined contribution arrangements, we assumed that both employer and employee contributions would each reduce by 5 percentage points (as this is approximately the contribution that would have needed to be saved to provide the additional benefits now being provided by the State Pension). For defined benefit schemes, contributions would reduce to reflect the impact of integration with a higher Pillar 1 benefit.
- Tax relief on Pillar 2 contributions: None.
- Tax on investment returns: Assumed to be taxed at 20%.

4.3.2 Financial projections

The financial projections for the enhanced Pillar 1 system are summarised in Table 4.5 below, where they are compared against the projected cost of the existing Pillar 1 system. As can be seen, even assuming that the entire increase in the Pillar 1 pension would be taxed at 20%, there is a very considerable projected increase in cost.

Table 4.5: Projected public pension spending to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Assuming pension of 34% GAIE	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
Assuming pension of 50% GAIE	4.4%	5.4%	7.2%	9.5%	12.8%	14.8%
Projected additional spend	1.4%	1.7%	2.3%	3.0%	4.1%	4.7%
Less additional tax revenues ¹⁹	(0.3%)	(0.3%)	(0.5%)	(0.6%)	(0.8%)	(0.9%)
Net additional cost	1.1%	1.4%	1.8%	2.4%	3.3%	3.8%

Abolishing tax reliefs on private Pillar 2 pensions leads to projected net cost savings of roughly 1.5% of GNP, as can be seen from Table 4.6.

Table 4.6: Private-sector Pillar 2: projected net Exchequer costs to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Assuming maintain status quo	1.6%	1.8%	1.8%	1.7%	1.4%	1.4%
Assuming abolition of tax reliefs	(0.2%)	(0.2%)	(0.2%)	(0.1%)	(0.1%)	0.0%
Net cost savings	1.4%	1.6%	1.6%	1.6%	1.3%	1.4%

Bringing together the results from Table 4.5 and Table 4.6, we see very clearly that increasing the Pillar 1 pension to 50% of GAIE in exchange for abolishing tax reliefs on Pillar 2 pensions would lead to marginal short term savings (as pensions currently in payment which have enjoyed the benefits of tax reliefs would continue to be taxed as at present), but would add substantially to the long-term sustainability and affordability pressures in the Pillar 1 system.

Table 4.7: Net impact of diversion of tax relief on net Exchequer costs to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Net additional Pillar 1 cost	1.1%	1.4%	1.8%	2.4%	3.3%	3.8%
Net Pillar 2 cost savings	1.4%	1.6%	1.6%	1.6%	1.3%	1.4%
Net additional cost/(saving)	(0.3%)	(0.2%)	0.2%	0.8%	2.0%	2.4%

For that reason, we see the call to divert tax reliefs to fund an increase in the Pillar 1 pension on a (currently) cost-neutral basis as fundamentally unsound. The Pillar 1 system is already widely agreed to be suffering from serious long-term affordability problems and, increasing the level of the Pillar 1 pension along the lines outlined above would exacerbate those problems.

To put the additional costs in context, it is interesting to look at the implications for PSRI contribution rates. The recent actuarial review of the Social Insurance Fund found that contribution rates would need to increase immediately by 74% from their current levels in order to equalise contributions and benefits for the over the period to 2061 (assuming that the State Pension is pegged at 34% of GAIE).

This calculation was based on the following projections for the financial position of the Social Insurance Fund:

¹⁹ Assuming that the additional pensions yield tax revenues at 20%.

Table 4.8: Projected net income of the Social Insurance Fund 2006-2061

	2006	2011	2021	2031	2041	2061
Projected net income	0.4%	0.0%	(1.1%)	(2.7%)	(4.6%)	(6.4%)

Source: Table E1 of the Actuarial Review of the Social Insurance Fund (2007)

Adding in our projected net additional costs/savings from Table 4.7 gives the following picture:

Table 4.9: Projected net income of the Social Insurance Fund 2006-2056 adjusted to reflect Table 4.7 results

	2006	2016	2026	2036	2046	2056
Projections from Table 4.8 ²⁰	0.4%	(0.5%)	(1.9%)	(3.7%)	(5.1%)	(6.0%)
Results from Table 4.7	0.3%	0.2%	(0.2%)	(0.8%)	(2.0%)	(2.4%)
Total	0.7%	(0.3%)	(2.1%)	(4.5%)	(7.1%)	(8.4%)

Based on these calculations we estimate that PRSI contributions would need to immediately increase by 106% from their current rates (i.e. increase to just over double the current rates) in order to equalise projected benefit outgo and contribution income over the period to 2056 (compared to an immediate increase of 74% assuming no change to the current system).

4.4 Financial implications of diverting some tax reliefs to Pillar 1

Rather than completely abolishing tax reliefs, some have called for partial abolition. For example²¹:

“The government’s pension review should consider ... reviewing the options that are available for reforming the tax arrangements for private pensions. Among the options which ought to be considered are giving the tax relief as a tax credit at the standard rather than the marginal rate of tax, phasing out the tax free lump sum, lowering the income cap on contributions and the size of pension fund allowable for tax purposes, and taxing returns on pension investments”.

If, rather than assuming the abolition of all tax reliefs with the savings diverted to support an enhanced Pillar 1 pension of 50% of GAIE, we assume instead that a package of measures is implemented as described above, then we need first to find the current cost of the reliefs in question so that we can derive the increase in the State Pension that could be provided at no current cost.

The cost of the reliefs can be derived from an analysis of the notes in Appendix C in the Green Paper. By changing the marginal tax rate from 38% to 20% we calculate that a saving of €311 million would result. Adding in our estimate of the tax which could be raised by taxing investment returns (€864 million) and the cost of tax free lump sums (€131 million), we estimate that the tax revenue which would be available for reinvestment in the State Pension would be some €1.3 billion. This assumes that all higher rate taxpayers continue to make pension contributions as before, despite the reduction in tax relief. Allowing for some fall off in pension contributions, it seems

²⁰ Interpolated based on figures in Table 4.8

²¹ Tasc (2007), *Choosing your Future*, ed. Hughes & Stewart, page 91

reasonable to estimate that perhaps €1.0 billion might be available. An additional €1.0 billion in tax revenue would permit the State Pension to be raised to approximately 40% of GAIE at no additional current cost to the Exchequer.

The projected cost additional cost of a State Pension of 40% of GAIE is set out in Table 4.10.

Table 4.10: Projected public pension spending to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Assuming pension of 34% GAIE	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
Assuming pension of 40% GAIE	3.5%	4.4%	5.8%	7.7%	10.2%	11.9%
Projected additional spend	0.5%	0.7%	0.9%	1.2%	1.5%	1.8%
Less additional tax revenues ²²	(0.1%)	(0.1%)	(0.2%)	(0.2%)	(0.3%)	(0.4%)
Net additional cost	0.4%	0.6%	0.7%	1.0%	1.2%	1.4%

We estimate that the impact of reducing tax reliefs on private Pillar 2 pensions as described above, leads to the following projected net cost savings.

Table 4.11: Private-sector Pillar 2: projected net Exchequer costs to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Assuming maintain status quo	1.6%	1.8%	1.8%	1.7%	1.4%	1.4%
Assuming abolition of tax reliefs	1.0%	1.1%	1.0%	0.9%	0.6%	0.7%
Net cost savings	0.6%	0.7%	0.8%	0.8%	0.8%	0.7%

Bringing the two together we see that increasing the Pillar 1 pension to 40% of GAIE in exchange for reducing the tax reliefs on Pillar 2 pensions would again lead to marginal short term savings but would result in higher costs in the longer term. In summary, the same pattern of results as for the 50% Pillar 1 pension, albeit not as extreme.

Table 4.12: Net impact of diversion of tax relief on net Exchequer costs to 2056 as a % of GNP

	2006	2016	2026	2036	2046	2056
Net additional Pillar 1 cost	0.4%	0.6%	0.7%	1.0%	1.2%	1.4%
Net Pillar 2 cost savings	0.6%	0.7%	0.8%	0.8%	0.8%	0.7%
Net additional cost/(saving)	(0.2%)	(0.1%)	(0.1%)	0.2%	0.4%	0.7%

4.5 Alternative approach – increase reliefs for lower paid

As an alternative to granting relief on contributions at the standard rate rather than at the higher rate, one could choose instead to ensure equal treatment by granting relief at the higher rate to all.

This was one of the alternative systems which we investigated for the Pensions Board in our NPR report (termed “Alternative System 1” in that report).

Our detailed projections for this alternative system are set out in Chapter 9 of our NPR report, but in summary we found that, even assuming an increase in coverage rates

²² Assuming that the additional pensions yield tax revenues at 20%.

amongst the lower paid, the cost to the Exchequer was projected to be only slightly higher than the current system (and stable over time).

Table 4.13: 'Alternative System 1' versus current system

	2006	2016	2026	2036	2046	2056
Current system	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%
'Alternative System 1'	2.6%	4.2%	5.8%	6.0%	6.6%	7.2%
Net additional cost/(saving)	0.1%	0.2%	0.2%	0.1%	0.3%	0.2%

5 The impact of tax deferral

5.1 Introduction

It is widely accepted that tax reliefs or tax incentives to encourage supplementary pension provision are not a “cost” in the true sense of the word in that they represent tax deferred rather than tax foregone.

This point is made in the National Pensions Review:

“6.4 ... The amount of tax relief on pension contributions granted each year does not reflect the true Exchequer cost of that relief, as these reliefs generate additional taxable income in future years. A true assessment of the cost would be the value of these reliefs less the present value of the future additional tax income.

However, this net amount is not zero, i.e. the value of the future tax income is less than the value of the relief for a number of reasons:

- *The average rate of tax paid in retirement on the additional income is usually lower than the rate at which income tax relief was granted*
- *The tax free lump sum at retirement exempts a significant part of the retirement fund from any tax at all, usually between 25% and about 35% (depending on the Revenue Commissioners rules relating to the amount that can be taken as a tax-free lump sum).*

It should be noted that the rate of tax relief granted on employer contributions is usually less than that granted on employee contributions, and will often be less than the average rate of tax in retirement.”

Similarly, Munnell (1991), writing in a United States context, argued that:

“A better estimate of the annual revenue loss resulting from deferral would be the difference between (1) the present discounted value of the revenue from current taxation of employer contributions and pension fund earnings as they accrue over the employee’s working life, and (2) the present discounted value of the taxes collected when the employer’s contributions and investment returns are taxable to the employee after retirement. To estimate the annual tax expenditure in this way requires assumptions about the average age of covered workers, the typical retirement age, life expectancy at retirement, the rate of earnings on pension reserves, the appropriate discount rate and marginal tax rates for workers and retirees”.

These comments support the view that the true cost of tax reliefs cannot be measured simply by looking at the rate of relief obtained on contributions, but also needs to take account of the tax paid in the future as a result of having made those contributions.

5.2 Analysis of impact of tax deferral

We can take Munnell’s approach and adapt it to apply it in an Irish context, allowing for employer and employee contributions, tax and PRSI reliefs, tax-free lump sums etc.

If we further refine the approach by expressing the present value of net reliefs (i.e. offsetting the stream of projected future tax revenues against the stream of projected future reliefs and taking the present value of the projected net relief/revenue in each future year) as a percentage of the present value of projected contributions, we can

derive what we can term the “net effective rate of tax relief”. This measure captures the tax revenues which will accrue in the future in return for the reliefs granted and is thus a better measure than the headline rate of relief²³.

If we look at the results for a single individual, aged 40 and contributing 5% of salary to a pension, with a further 10% of salary being contributed by his employer, we get the following results as set out in Table 5.1 and Figure 5.1. The detailed assumptions behind these calculations are set out in Appendix D.

The “headline rate of relief” includes the employee tax relief and the employee PRSI relief. The “net effective rate of relief” is as described above.

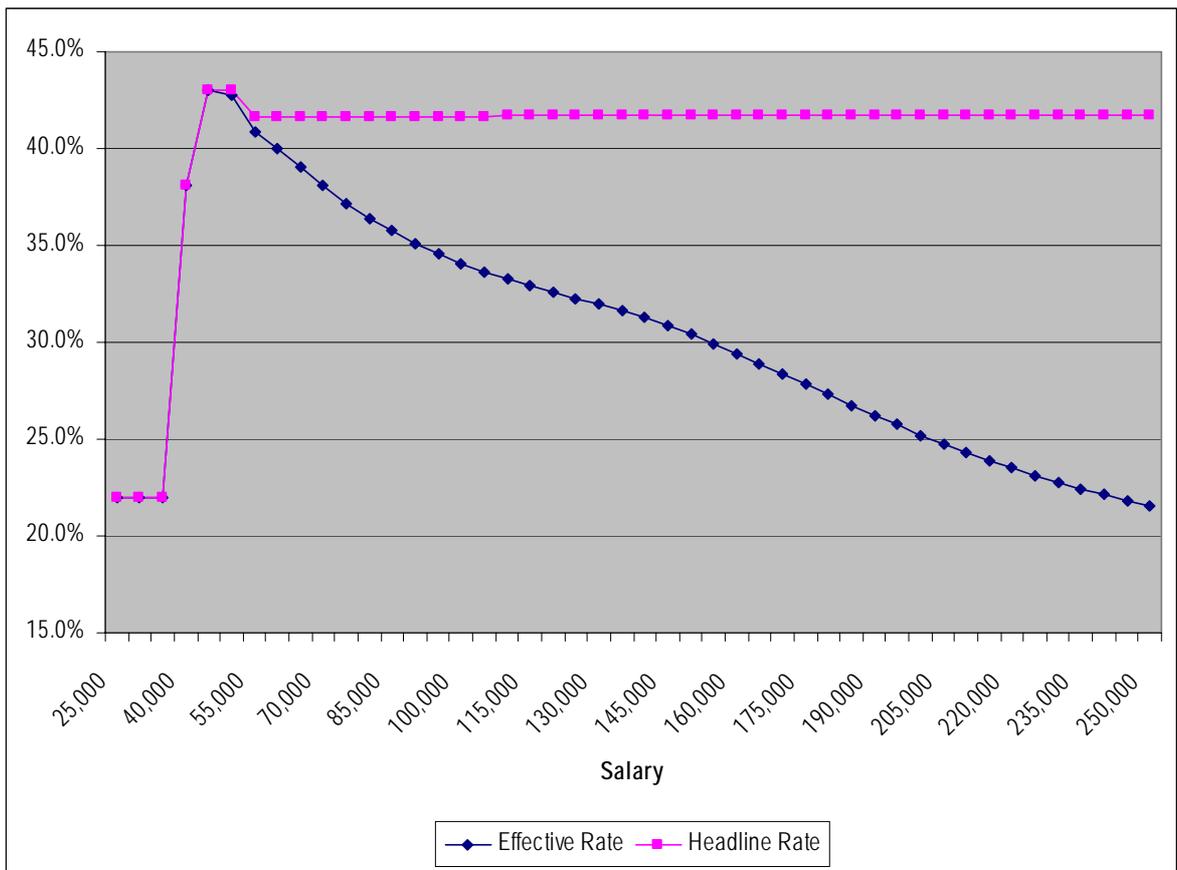
Table 5.1: Comparison of headline and effective rates of relief on pension contributions

Salary	Headline rate of relief	Net effective rate of relief
25,000	22.0%	22.0%
30,000	22.0%	22.0%
35,000	22.0%	22.0%
40,000	38.1%	38.1%
45,000	43.0%	43.0%
50,000	43.0%	42.8%
55,000	41.7%	40.8%
75,000	41.7%	37.2%
100,000	41.7%	34.1%
125,000	41.7%	32.3%
150,000	41.7%	30.4%
175,000	41.7%	27.8%
200,000	41.7%	25.2%

Source: Life Strategies calculations

²³ By “headline rate” we mean the value of current year tax and PRSI reliefs expressed as a percentage of the current year pension contributions.

Figure 5.1: Comparison of headline and effective rates of relief on pension contributions



These results are quite interesting. In summary, we find that at higher salary levels (above €45,000) the effective rate of relief is lower than the headline rate and the effective rate falls as you move up the income band (assuming no change to the contribution rate). The effective rates of relief for the very highest earners are lower than the effective rate for someone earning €40,000.

For those earning up to €45,000, the pension resulting from a 15% contribution rate is projected to be too low to incur any tax liability in retirement. Therefore, for these people, their effective rate of relief is the same as the headline rate. For those earning more than €45,000, the tax which will be payable in retirement reduces the effective rate below the headline rate. The higher the salary (and hence the higher the ultimate pension), the lower the effective rate.

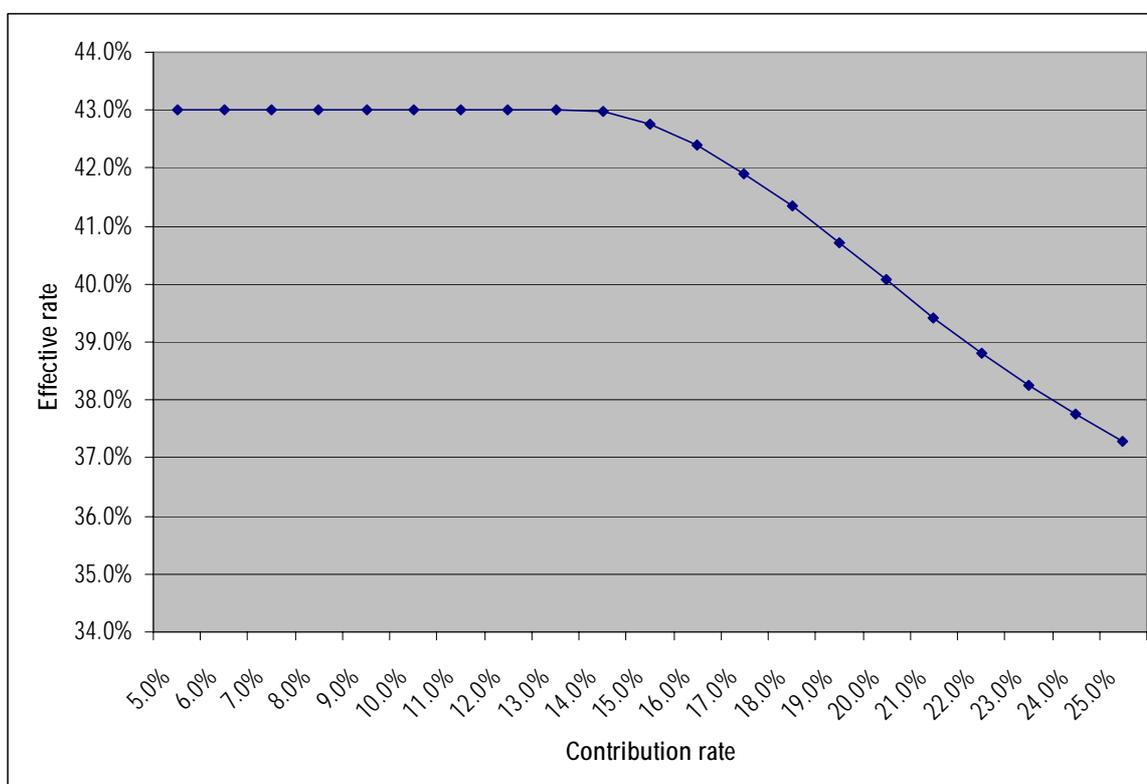
It also shows, of course, that because relief is given at the marginal rate, those who do best from the current system (in terms of getting the best effective rate of relief) are those whose pension contributions are fully relievable at the top rate of tax but who do not pay any tax on their resulting pension in retirement. The precise salary range in question will depend on the size of the pension contribution but, in the example above of a 15% contribution, those earning between €41,650 and €45,700 get the maximum net effective rate of 43%.

Table 5.2 and Figure 5.2 show that you get a similar effect if you increase the pension contribution rate for any given level of earnings. The figures are for a 40 year old on a salary of €50,000.

Table 5.2: Effective rate of relief for different contribution levels

Contribution rate	Net effective rate of relief
5%	43.0%
10%	43.0%
15%	42.8%
20%	40.1%
25%	37.3%

Figure 5.2: Effective rate of relief for different contribution levels



This suggests that the current system exhibits a desirable characteristic, which is that the overall effective rate of relief falls for higher contributions.

In summary, therefore, the current system gives the most relief to those earning just above the standard rate cut-off point and contributing an appropriate amount to their pension.

APPENDICES

6 Appendix A – Summary of assumptions

6.1 Introduction

In this Appendix we summarise the assumptions used in the projections in our NPR report. The reader is referred to Chapters 5, 6 and 7 of that report for more details.

6.2 Demographic assumptions

In relation to demographic projections, we used one of the CSO's population projections (specifically their M2F2 variant)²⁴ as our central assumption. In summary, this projection assumed continued improvements in mortality rate, a fall in the total fertility rate and that there would be continued net migration but at more moderate levels than has been recently experienced²⁵.

Based on these assumptions, some summary measures of the projected population and its structure are set out in Table 6.1.

Looking first at the total population, it can be seen that the population is forecast to rise from 4.17 million in 2006 to 5.22 million in 2056, an increase of 25%. Of greater interest from a pensions perspective is the projected change in the structure of the population. The proportion of the population aged 65 and over is projected to rise from 11% in 2006 to 29% in 2056. Looking at this process of population ageing in terms of the dependency ratio, we can see that the old-age dependency ratio²⁶ rises from 16% in 2006 to 53% in 2056.

Table 6.1: Population structure 2006 to 2056 (000s)

	2006	2016	2026	2036	2046	2056
0-14	868	969	889	822	844	807
15-64	2,834	3,048	3,176	3,176	2,980	2,879
65+	464	620	844	1,105	1,403	1,532
Total	4,165	4,638	4,909	5,104	5,228	5,219
0-14	21%	21%	18%	16%	16%	15%
15-64	68%	66%	65%	62%	57%	55%
65+	11%	13%	17%	22%	27%	29%
Old-age DR	16%	20%	27%	35%	47%	53%

²⁴ Central Statistics Office (2004), Population and Labour Force Projections 2006 to 2036

²⁵ The precise net inflows are as follows:

- +30,000 per annum in 2002/2006
- +20,000 per annum in 2007/2011
- +10,000 per annum in 2012/2016
- + 5,000 per annum in 2017/2021
- + 5,000 per annum in 2022/2026
- + 5,000 per annum in 2027/2031
- + 5,000 per annum in 2032/2036
- + 5,000 per annum in 2037/2056

²⁶ Defined as the population aged 65 and over expressed as a percentage of the population aged 15-64.

One important consequence of using the CSO's demographic assumptions is that, as their mortality assumptions incorporate an allowance for future mortality improvements, the average life expectancy is projected to increase considerably over the period in question. This has significant implications for projected pension costs.

Table 6.2 shows the projected remaining life expectancy for males and females reaching age 65 at various years in the future²⁷. In summary, those reaching 65 in 2056 are projected to live 6 years longer than those reaching 65 next year.

Table 6.2: Life expectancy at 65, 2006 to 2056

	2006	2016	2026	2036	2046	2056
Male	16.0	17.6	19.2	20.6	21.3	22.0
Female	19.4	20.9	22.4	23.9	24.6	25.3

In summary, those reaching 65 in 2056 are projected to live 6 years longer than those reaching 65 this year – a projected increase in life expectancies of over 1 year per decade.

6.3 Economic assumptions

In assessing pension systems it is necessary to be able to express aggregate pension assets, benefits, contributions etc., as percentages of GNP. For this reason, we needed to generate a long-run GNP series (out to 2056). The methodology and assumptions which were used in projecting future GNP are set out in detail in Chapter 5 of our NPR report. In summary, however, the growth in GNP was projected as a function of growth in employment and productivity.

The resulting GNP projections are summarised in Table 6.3.

Table 6.3: GNP projections (€m), 2006 to 2056

	2006	2016	2026	2036	2046	2056
Real GNP (2004 base)	134,735	192,804	243,775	297,160	346,570	413,743
Average 10 year growth % p.a.		3.7%	2.4%	2.0%	1.6%	1.8%
Nominal GNP	141,004	245,962	379,092	563,309	800,846	1,165,440
Average 10 year growth % p.a.		5.7%	4.4%	4.0%	3.6%	3.8%

Assumptions for earnings and price inflation were also derived, consistent with the GNP projections. In summary:

- Real wage growth is assumed to equal productivity growth (3% currently, falling to 2% p.a. by 2021 and staying at that rate thereafter).
- Price inflation is taken as equal to the GNP deflator used in the GNP projections (2.4% currently, falling to 2% p.a. by 2007 and staying at that rate thereafter).

We also made certain assumptions for future investment returns on pension fund assets, as follows:

²⁷ For ease of comparability with CSO and other publications, these are quoted as "period" rather than "cohort" life expectancies. Because of the assumption of continued mortality improvements, the actual projected ("cohort") life expectancies will be greater than "period" life expectancies.

Table 6.4: Assumed prospective real investment returns (% p.a., net of trading costs)

	Assumed rate of return
Defined benefit schemes	3.9%
Defined contribution arrangements	3.6%
National Pensions Reserve Fund	4.6%

The investment returns quoted in Table 6.4 apply to pre-retirement assets. For the post-retirement phase we assumed that benefits would be annuitised using annuity rates which are based on a real return assumption of 2% p.a.

Once again, the details are set out in Chapter 5 of our NPR report.

6.4 Labour force & earnings assumptions

In order to project the size of the labour force we made assumptions about the level of labour force participation by gender and age which we then applied to the projected population numbers. In summary, we held the male age-specific participation rates constant at their current levels, whilst for women we assumed a degree of increase in the participation rates in the 35-54 age range. The full details are provided in Chapter 5 of our NPR report.

The resulting labour force projections are summarised in Table 6.5. In summary, the labour force is projected to grow over the period to 2026, to stabilise at around the 2026 level until 2036 and to fall back thereafter. This reflects the projected development of the population over that period (see Table 6.1).

The age structure of the labour force is also projected to shift considerably over time. Under-35s account for almost 44% of the 2006 labour force, but this is projected to fall to 32% by 2056. Conversely, over-55s account for 12% of the 2006 labour force, but 19% of the projected 2056 labour force.

Table 6.5: Labour force projections (000s), 2006 to 2056

	2006	2016	2026	2036	2046	2056
15-24	291	242	285	277	239	245
25-34	585	537	446	520	491	431
35-44	490	634	567	476	550	521
45-54	392	496	599	538	454	523
55-64	207	254	303	369	324	281
65+	36	49	68	89	113	123
Total	2,001	2,213	2,268	2,268	2,170	2,125

In arriving at a figure for the current level of income earned by the labour force, we used income figures taken from analysis of PRSI data for 2003 which was supplied by the Department of Social and Family Affairs. As well as providing the total level of income²⁸, this data also analysed the PRSI payers by age and income decile.

Based on this data, we aggregated some deciles to arrive at five income bands (not quintiles). In our projections we assumed that, for each age, the proportion of the

²⁸ The income figures provided are net of employee pension contributions.

labour force in each of the income bands would remain constant over time. We further assumed that total labour force earnings would inflate in the future at a rate consistent with our economic assumptions.

Based on the PRSI data, and allowing for earnings inflation for the period from 2003-2005, the total earnings of the labour force aged 18-64 were estimated at some €57 billion in 2005.

Further detail on our labour force & earnings assumptions is provided in Chapter 5 of our NPR report.

6.5 Pension system assumptions

6.5.1 Current system

The detailed assumptions which we used in assessing the current system are set out in Chapter 7 of our NPR report. The following paragraphs provide a high-level summary of some of the more important assumptions.

Retirement age

We assumed a retirement age of 65 (other than in the case of the State Pension (Contributory) where we assumed 66).

Pillar 1

Data from the DSFA provided us with information on the proportion of the over-65 population in receipt of various benefits. By making assumptions on how these proportions will move over time, we calculated the number of recipients under the various payment categories out to 2056, using our population projections. The relevant assumptions, which were supplied by the DSFA, are detailed in Table 5.1 in our NPR report.

With regard to payment rates, we assumed that the amount of the State Pension (Contributory) increases to 34% of the previous year's gross average industrial earnings with immediate effect. We then assume that it is indexed from that base in line with earnings inflation and that the same absolute increases (i.e. in monetary amounts) are applied to other payments.

Section 7.3 of our NPR report provides more detail on the Pillar 1 projections.

PRSI receipts

Under our assumptions (about the growth in the labour force, earnings and GNP), PRSI receipts are projected to represent a broadly constant proportion of GNP over time (approximately 4.3% of GNP). We considered 85% of total PRSI receipts as being 'pension-related' (i.e. 3.7% of GNP). Please see section 7.4 of our NPR report for more detail on this point.

Public service Pillar 2

The Department of Finance provided us with projections of the gross benefit outgo in relation to public service pensions out to 2056. These projections were essentially an updating of the work undertaken by the Commission on Public Service Pensions in 2000 and in most cases the assumptions follow those used by the Commission, with some updating in certain areas.

The projections are on the basis that public service employment numbers remain constant at approximately 280,000 (as measured on a full-time equivalent basis). Section 7.5 of our NPR report provides a detailed description of the approach taken.

Private sector Pillar 2

We gathered data on the current private-sector Pillar 2 system (i.e. membership, contributions, assets, pensioners etc.) from various sources and made assumptions about how each of these items would evolve in the future.

With regard to membership, we assumed that private sector Pillar 2 coverage rates remain constant at their current levels. New entrants to defined benefit schemes are assumed to dry up over the next 20 years (with occupational defined contribution and personal arrangements making up the difference).

Please refer to section 7.7 in our NPR report for more details on our approach to projecting the private sector Pillar 2 system.

National Pensions Reserve Fund

We projected the future size of the NPRF, allowing for contributions of 1% of our projected GNP figures and assuming a real investment return of 4.6% p.a. (see section 6.8.3 of our NPR report for details on the derivation of this rate). Drawdowns were assumed to commence in 2025 (at a low level) with subsequent annual drawdowns increasing in line with the growth in the over-65 population. More detail on our methodology and assumptions for the NPRF projections may be found in section 7.6 of our NPR report.

7 Appendix B – Pillar 1 projection methodology

7.1 Costs of Pillar 1 pensions

Our approach to projecting the costs of Pillar 1 pensions can be summarised as follows. Based on current data, we know the proportion of the population aged 65 and over in receipt of various payments. By making assumptions on how these proportions will move over time, it is possible to calculate the number of recipients under the various payment categories out to 2056, using our population projections. With regard to benefit levels, we assume that the contributory State pension is indexed to growth in nominal earnings and that the same absolute increases (i.e. in monetary amounts) are applied to other payments. Our assumed values for nominal earnings growth are derived in turn from the assumptions on productivity growth and inflation which were used in the GNP projections.

The detailed assumptions regarding the proportion of the population in receipt of various benefits are set out in our NPR report. Some of the more important assumptions include:

- The proportion of males age 65 and over who qualify for a full contributory pension is assumed to rise from the current level of 41.7% to 80% over the period to 2056. The corresponding increase for females is from 11.7% to 57.0%. These increases capture, inter alia, the increasing levels of female participation and the increasing numbers of public servants covered by the PRSI system.
- The proportion of the over-65 population in receipt of non-contributory pensions is assumed to fall from the current level (19.1% of men; 20.3% of women) to 2% by 2056.
- The percentage of the over-65 population receiving no social welfare benefits is assumed to fall to 2% by 2056.

In our projections, we have included the following: contributory and retirement pensions, widow(er)s' contributory and non-contributory pensions, invalidity payments to people aged 65 and over and some other miscellaneous payments to people aged 65 and over. We have not included free schemes or administrative costs.

Our projections are based on the contributory pension being 34% of the previous year's gross average industrial earnings in 2006, with increases in future in line with earnings as set out above.

8 Appendix C – Pillar 2 projection methodology

8.1 Tax Relief on Contributions

In order to determine the cost of tax (and PRSI) relief on employee contributions, we calculated an appropriate marginal tax rate and PRSI rate for each earnings band and applied these to the total contributions paid by the members in each band. We also allowed for the employer PRSI relief on employee contributions. Employer contributions were given tax relief at the corporation tax rate²⁹. We assumed no changes to tax or PRSI rates over time.

Table 8.1 summarises the projected amount of tax (& PRSI) relief on private sector Pillar 2 contributions, as set out in our NPR report.

Table 8.1: Relief on private sector Pillar 2 contributions 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Private sector contributions	4,274	6,554	8,288	9,588	10,598	12,496
Tax relief	1,413	2,263	2,981	3,569	4,002	4,802
Tax relief as % of GNP	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%

Adding in the cost of the BIK exemption on employers' contributions we get the following results:

Table 8.2: Relief on private sector Pillar 2 contributions 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Private sector contributions	4,274	6,554	8,288	9,588	10,598	12,496
Tax relief	1,940	3,014	3,822	4,386	4,814	5,681
Tax relief as % of GNP	1.4%	1.5%	1.5%	1.4%	1.3%	1.3%

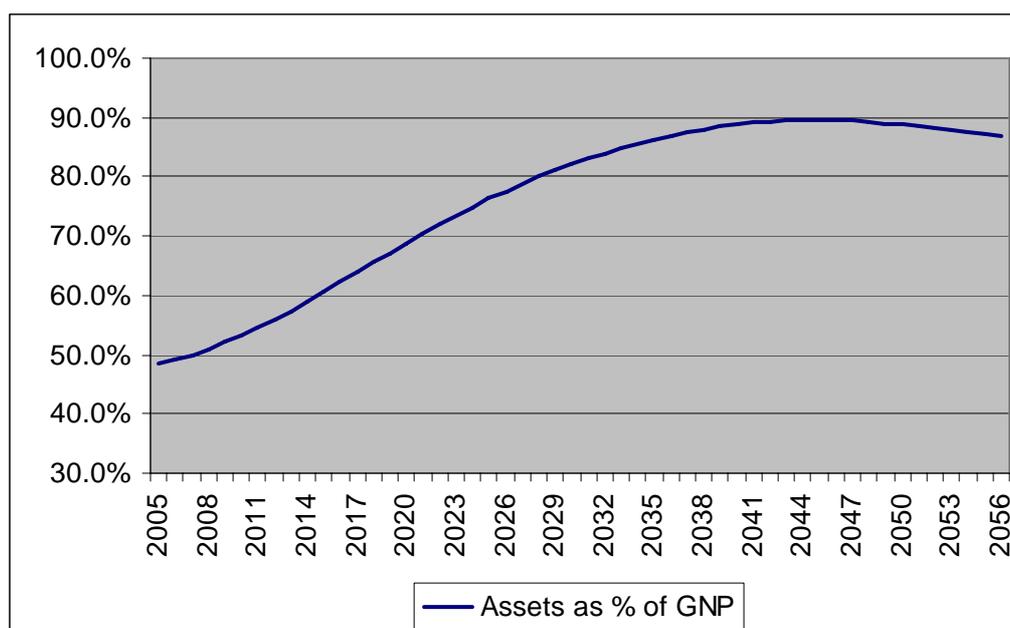
8.2 Assets

Our projection of Pillar 2 pension fund assets took as its starting point the estimated total value of assets currently held by defined benefit, defined contribution and personal pension arrangements. These total assets were then apportioned across the current membership to give the opening position. The opening assets were then rolled forward allowing for changes in membership, contributions received, benefits paid, expenses and investment returns.

As can be seen from Figure 8.1, the size of private sector Pillar 2 assets (expressed as a percentage of GNP) is projected to grow from its current level of close to 50%, peaking at approximately 90% in the mid-2040s, before falling back slightly by 2056.

²⁹ In our NPR report, we did not allow for the BIK exemption on employers' contributions.

Figure 8.1: Growth in private sector Pillar 2 assets as % of GNP, 2006-2056



8.2.1 Tax foregone on investment income & gains

Based on the projected investment earnings on the assets in 8.2, we calculated the tax foregone by the Exchequer from not taxing those investment earnings. In deriving this cost we assumed that, were they not tax exempt, pension fund investment earnings would be taxed at 20% each year.

This rate is consistent with the rates of tax currently levied on deposit interest (20%) and on life assurance investment products (23%, comprising a basic 20% plus an additional 3% to allow for the effect of deferment, as life policy investments are taxed on maturity rather than on a year-by-year basis).

Table 8.3: Private sector Pillar 2 investment income & gains 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Investment income & gains	2,825	4,954	7,853	10,766	12,987	15,013
Tax relief at 20%	565	991	1,571	2,153	2,597	3,003
Tax relief as % of GNP	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%

In arriving at the net Exchequer cost of the current system, we include the “cost” of this tax foregone although it is open to debate as to whether this is a real cost (see the comments in section 3.3 above on this point).

8.2.2 Benefit payments

We first estimated the total amount of private-sector pensions currently in payment by analysing figures from various data sources.

Having determined the pensions payable in the future to existing pensioners, the next step was to add the pensions payable to future pensioners. These were determined (for both DB and DC pensioners) by projecting their assets at retirement, using the assumptions outlined above regarding contributions, investment returns, take-up of the tax-free lump sum and expenses.

We assumed full take-up of the tax-free lump sum (modelled as 25% of the retirement fund), with the remaining assets converted into a pension using a suitable annuity rate at retirement allowing for mortality, expenses and investment returns as set out above. The projected pension payments are shown in Table 8.4.

Table 8.4: Private sector Pillar 2 pension payments 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Pension payments	1,138	1,822	3,473	6,294	9,915	11,975

8.2.3 Tax revenue on benefit payments

Having determined the projected pension payments in 8.2.2, we then assumed that these would be taxed at 20%, with a further allowance for the 2% health levy, bringing total revenue to the Exchequer of 22% of the pension.

The justification for our choice of 20% as the marginal tax rate lies in the fact that the average pension payment to private-sector pensioners is currently some €8,000 p.a. Private sector pensioners will generally also have additional sources of retirement income (Pillar 1 pensions and Pillar 3 income), but on the other hand we also need to allow for the effect of tax free allowances etc. Overall, therefore, an assumption of 20% is probably not unreasonable.

The average pension is projected to increase over time, so some increase in the assumed tax rate could be justified over time. We decided, however, to hold the tax rate constant at 20% (which is arguably a little on the low side).

Table 8.5 summarises the projected amount of tax (& PRSI) revenue from private sector Pillar 2 pensions in payment.

Table 8.5: Revenue from private sector Pillar 2 pensions in payment 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Private sector pensions	1,138	1,822	3,473	6,294	9,915	11,975
Tax revenue	250	401	764	1,385	2,181	2,635
Tax revenue as % of GNP	0.2%	0.2%	0.3%	0.4%	0.6%	0.6%

9 Appendix D – Assumptions for Chapter 5

The following assumptions were used for the effective tax rate calculations in Chapter 5:

Table 9.1: Assumptions used in calculations in Chapter 5

Age	40
Retirement Age	65
Salary Inflation	4.00%
Fund growth (net of charges)	6.00%
Discount Rate	4.00%
Tax Band 1 - under 65	€18,300
Tax Band 1 - 65+	€19,925
Tax Band 2	€35,400
Employee PRSI Limit	€50,700
Employee PRSI rate	4.00%
Health Levy	2.00%
Employee contribution rate	5%
Employer contribution rate	10%
Top Tax Rate	41%
Standard Tax Rate	20%
Tax on fund growth	0%
Tax Free Lump Sum	25%
Annuity Rate at retirement	5.00%
State Pension	€11,612

10 Appendix E – Calculation of public sector employer pension contributions

We calculated the total (notional) public sector employer contributions for 2006 as just over €2.7 billion.

Our calculations are set out in Table 10.1.

Table 10.1: Calculation of public sector employer pension contributions

Sector	2006 Pay Bill (€m)	Assumed benchmarking reference grade	Benchmarking contribution rate	Pension contribution (€m)
Health	6,197	Nurse	13.8%	855
Education	4,662	Teacher	19.4%	904
Civil Service	1,826	Civil Servant	21.3%	389
Security	1,411	Garda	32.9%	464
Non-comm. State Bodies	502	Civil Servant	21.3%	107
Total	14,598			2,720

Notes to Table 10.1:

1. The pay bill for 2006 is taken from Table VII (“Sectoral Breakdown of Exchequer Pay Bill”) in the “Analysis of Exchequer Pay and Pensions Bill 2001-2006”, produced by the Central Pay Policy Section of the Personnel and Remuneration Division, Department of Finance and dated June 2006.

The booklet is available on the Department of Finance website at:

<http://www.finance.gov.ie/documents/publications/other/Payanalysis2006.pdf>

2. The 2006 figures have been used for comparability with the other figures quoted in Chapter 3. Note that the comparable figure for 2007 is in excess of €2.9 billion (as the public sector pay bill grew by 8.2% in 2007).
3. For each sector of the public service we have calculated the notional employer pension contribution using the employer contribution rate for the most suitable reference grade from the list of grades chosen for analysis in the Report of the Public Service Benchmarking Body (2007). The rate used is the rate for the “post 2004 cohort” (see tables in section 5 of Appendix 8 of the Benchmarking Body’s report).

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APPENDIX 2

Defined Contribution Member Options – Annuities and Approved Retirement Funds

IRISH ASSOCIATION OF PENSION FUNDS PAPER

November 2007



Defined Contribution Member Options – Annuities and Approved Retirement Funds

Summary

This paper addresses the issue of how some individuals who accumulate retirement funds throughout their working lives on a defined contribution (DC) basis are restricted in how they can use those funds when they reach retirement age. This issue has been highlighted by the Irish Association of Pension Funds (IAPF), among others, in the past as lacking in logic and being particularly unfair on a specific group of individuals, i.e. PAYE workers who are members of DC arrangements.

These individuals carry investment risk throughout their careers but are then restricted to purchasing an annuity when they come to retirement. By purchasing an annuity the individual is forced to lock into a low risk/low return investment for the remainder of their lifetime, which on current projections will be for over 20 years.

This restriction only applies to DC PAYE workers and does not apply to self-employed individuals, proprietary directors or individuals who save for retirement through Personal Retirement Savings Accounts (PRSAs). These also carry the investment risk in their accumulation of retirement funds but are allowed to carry on that form of investment in retirement, if they choose to do so, by transferring to an Approved Retirement Fund (ARF).

This paper sets out the reasons why we believe this option should be available to all individuals who accumulate retirement funds on a DC basis:

- Extending the ARF option to DC members creates a level playing field and it is logical and reasonable to do so as they carry investment risk throughout their careers and should be free to continue to do so, if they wish and where appropriate, in retirement
- This option is not appropriate for DB members as they do not have to carry the same risk in accumulating their retirement benefits. Furthermore they accumulate a benefit and not a fund which is fundamentally different
- Any concerns relating to individuals not properly managing their ARF can be dealt with by appropriate regulation and by strengthening the protection measures currently in place
- Allowing the option to avail of an ARF removes the timing risks associated with compulsory annuitisation and therefore reduces a risk that only applies to DC members
- Transferring to an ARF allows individuals the opportunity to achieve higher returns on their funds in retirement
- Where higher returns are achieved there should be an increase in the overall tax collected on retirement income. Any taxation issues that exist on ARFs should be dealt with by taxation measures and not by exclusion
- The ARF option facilitates those who wish to defer or phase their retirement from the workforce
- It removes the concern that DC members have of losing their accumulated savings to the annuity provider should they die shortly after commencement of the annuity

The conclusions reached in this paper are similar to those reached in the Review of the Irish Annuities Market Report for the Pensions Partnership Review Group prepared by Indecon and Life Strategies. In particular we note some of the points made in relation to annuities:

“Demand arises primarily from defined contribution occupational pension scheme members who have no other option but to buy an annuity”

“We are however concerned about a market where few consumers appear to choose the particular product the absence of legislative obligation to do so in order to secure a tax subsidy”

“However, now that the ARF option has been further extended (including to all PRSA holders), we see no logical reason why retiring members of defined contribution schemes should be subject to different rules in this regard”

Background

Retirement provision involves the accumulation of assets during an individual's working lifetime in order to provide income during the individual's retirement. In Ireland, as is common in many countries, the State provides incentives for the individual to accumulate those savings. This is provided by allowing tax relief on employee contributions to pension arrangements. Employers also play a large role in contributing towards the retirement savings of their employees. Their contributions are allowable as a business expense and employees are not subject to benefit in kind tax on those contributions. The investment income of pension arrangements is not subject to tax. The State taxes the income that the individual receives in retirement and therefore the tax incentive provided on the initial savings is a form of deferred tax.

Traditionally, retirement provision was relatively straightforward in that assets were accumulated through a combination of individuals' and employers' contributions paid during the individuals working lifetime to a pension scheme established by the employer. These contributions were invested with a life assurance company who managed the assets with a view to achieving a reasonable rate of return on the assets.

Defined Benefit Provision

Where the pension scheme operates on a defined benefit (DB) basis, each individual member accrues a benefit entitlement, usually based on the member's length of service and final salary. At retirement, the member has the option to surrender some of the benefit for a tax-free lump sum. The remaining benefit is paid as a pension. For all but the largest of schemes, this was normally done by the trustees purchasing an annuity from a life office. The life office then assumed the responsibility of paying the pension amount for the remainder of the individual's life. This was purchased using the general funds of the scheme, as in DB schemes it is a benefit rather than a fund that is accumulated for the individual member. The largest of schemes would pay pensions directly from the fund as they had a sufficient number of pensioners to ensure that the financial risk to the scheme of individual members living longer than expected was not disproportionate and would in all likelihood be balanced by members who would have a shorter than predicted life.

Defined Contribution Provision

Where the pension scheme operates on a DC basis, a fund is accumulated for the individual member from the contributions paid by the member and the employer, combined with the investment return achieved on those. Effectively each member accumulates an individual pot of money. At retirement the individual member has the option to take some of their fund as a tax-free lump sum and the balance of the assets would be used to purchase an annuity paid by a life office. Self-employed individuals save for their retirement in the same way through an individual contract with a life office.

Changing Environment

In more recent times retirement provision has become more complicated with more choices available both in terms of how to accumulate savings and the means of providing the income in retirement. This has inevitably created anomalies and inequities and this paper examines one of these.

In terms of the means of accumulating retirement savings the traditional employer established pension scheme still exists. While many pension schemes invest with life assurance companies there are also other options available. Larger schemes, in particular, invest directly with investment management firms. Many smaller schemes also invest directly, particularly schemes for company directors that largely invest in property (and can borrow through the scheme to do so). Individuals can now also provide for their retirement through PRSAs. These are individual contracts between an individual and the PRSA provider. Employers can contribute but most PRSAs that have been sold do not have an employer contribution.

Annuities

There has been a significant increase in the cost of annuities. The main reasons for this increase are that people are living longer and interest rates have been at historically low levels. Furthermore the replacement of the Irish pound with the Euro means it is likely that these low levels of interest will persist for the foreseeable future. There are other issues particular to Ireland, especially as the number of companies providing annuities is limited and this has the potential to make the market inefficient.

The fact that people are living longer is a very welcome development but it does mean that individuals have to fund for a longer retirement. Figures from the Society of Actuaries in Ireland show that, in 1980 a typical 65 year old male pensioner could expect to live for another 14.6 years. Today, a typical 65 year old male pensioner could expect to live for another 20.2 years.

However because of this increase in life expectancy and the effect of low interest rates, to provide that pensioner with an annuity of €1,000 per annum in 1980 would have cost €8,330. In 2007, the same annuity would have cost €24,500.

Effect on DB benefits

This substantial increase and the uncertain future direction of some of the drivers of the increase has resulted in DB schemes paying pensions direct from the scheme funds rather than purchasing an annuity. In particular there is no consensus on the future level of improvement in life expectancy and there is a body of opinion that insurers are overestimating this when pricing annuities. Insurers argue that they have to be prudent as they have a one-off opportunity to price a contract that could last in excess of 20 years.

Interest rates have been consistently low in recent years. This has the effect of increasing annuity prices as life offices are effectively required by regulations relating to solvency to match their annuity liabilities with bonds which largely track interest rates. Therefore any trustees who believe interest rates will rise may choose to defer purchasing an annuity until this happens and impacts on annuity prices.

There are other factors that add to the cost of annuities such as solvency requirements, administrative costs and profit margins. Many trustees view these as being disproportionate to the overall cost of an annuity. The recent Review of the Irish Annuities Market by Indecon and Life Strategies estimates that for a male aged 65 the annuity cost is 18% more than the cost assumed by a pension fund and 21% more for a 65 year old female.

Furthermore, schemes may be able to ascertain from their own data if they have particular life expectancy patterns that may differ from those of the general population. Where that is the case, and if life expectancy of their members is less than the general population, it may make better financial sense to pay pensions directly from the scheme funds as the pension is likely to be paid for a shorter period than that which an annuity provider would assume.

This has no direct effect on the benefits a member will receive from a DB scheme as it is the member's benefit that is defined and the cost accrues to the overall fund. Obviously, the greater the cost to the fund the greater the resultant strain on the fund. This increase in costs had led to scheme sponsors considering the sustainability of schemes and in many cases to the closing of schemes to new entrants or even to the winding up of schemes. Furthermore, schemes have to value their pensions in payment on the basis of what it would cost to purchase equivalent annuities in the marketplace when calculating whether or not the scheme meets the funding standard. Therefore, schemes that take the view that it makes more financial sense to pay pensions directly from the scheme funds may still have to set aside the difference in the cost to them and the cost of buying annuities in order to satisfy the funding standard.

Effect on DC Benefits

However, the increase in the cost of annuities has a direct impact on the benefits of DC members. Individuals need to have accumulated significantly more in savings in order to buy the same annuity. Using the example above an individual would have needed to have accumulated €8,330 in 1980 to

buy an annuity of €1,000 per annum. However, in 2007 the same individual would have needed to have accumulated €24,500 to buy an annuity of €1,000 per annum. Therefore the individual would need to have been saving almost 3 times as much in order to achieve the same result. As there has been no discernable increase in the contribution levels in DC arrangements the increase in annuity rates will have a severe impact on the income of DC members in their retirement. Indeed as individuals tend to now enter the workforce later and retire earlier than in 1980 the time over which individuals can accumulate their retirement savings has also shortened.

Approved Retirement Funds

The Finance Act, 1999 introduced a provision which allowed certain groups of individuals to transfer their accumulated funds at retirement to an ARF, once certain conditions are met. This effectively means that many categories of individuals can choose to continue to invest their accumulated funds and not to purchase an annuity at retirement age and draw down on those as and when they need to. This gives much more flexibility to those individuals especially when annuity rates are high at the point of retirement.

Originally this option was available to holders of Retirement Annuity Contracts, members of Retirement Annuity Trust Schemes (which are contract for self-employed individuals), Proprietary Directors and individuals entitled to rights from Additional Voluntary Contribution (AVC) arrangements. It was also made available to individuals who saved for retirement using PRSAs, when they came into being. This allows individuals who have taken investment risk throughout their working lives to have investment choice at the point of retirement.

In any case, a sizeable proportion of people with accumulated pension savings did not now need to purchase an annuity and could continue to invest their savings and draw down on those as and when they needed to. At the time of introduction there was considerable concern expressed by many parties, including the IAPF, regarding the merits of ARFs. Much of this related to the prospect of individuals, through a combination of poor investments and too many drawdowns, running out of funds.

Since the introduction of ARFs there have been many changes to the pensions landscape including consistent low levels of interest rates and higher assumptions of life expectancy which has led to higher annuity rates. Therefore while it would not have been unreasonable for someone at 65 expecting to live for 10 to 15 years to lock into an investment based on an assumption of 8% growth per annum, it does not seem so reasonable to force someone to lock into the same investment based on 4% growth per annum for 20 years or more.

Furthermore PRSAs have now been introduced and there has been a continuation of the growth of DC schemes which looks likely to be maintained.

Whilst there may be many issues with annuities, they have the advantage that they provide the certainty of a given level of income for life. There are some protections built into ARFs in that individuals wishing to avail of the option must prove they have a specified income of €12,700 per annum. If they do not they must transfer €63,500 to an Approved Minimum Retirement Fund (AMRF). This initial capital transferred to the AMRF can not be withdrawn until the individual is aged 75, at which stage it becomes an ARF.

Experience to date however has shown that, in reality, the high net worth individuals who have been able to transfer their accumulated retirement savings to ARFs have not been drawing down on them to the extent feared. As a means of addressing this issue, the Finance Act, 2006 included a deemed distribution tax whereby the Revenue Commissioners could tax ARFs where drawdowns are not being made.

Exclusion of DC Members

Members of DC schemes are excluded from the option of transferring to an ARF (except for any AVCs they might make). The IAPF strongly believes there is no logical basis for this exclusion. This exclusion means that there is not a level playing field among, otherwise, very similar forms of pension provision. What was already a complicated area, in terms of the format in which contributions can be paid and benefits taken, is now further complicated. PAYE DC members can only avail of the ARF option in respect of any AVCs that they pay. PAYE employees can however avail of the ARF option if

they arrange their retirement provision through a PRSA. The availability of the ARF option should not determine which form of retirement provision an individual or employer wishes to utilise. That choice should be based on what best suits the workforce and on the charges that apply. Many DC schemes can operate on significantly lower charges than a standard PRSA and this should be the dominant factor in making those choices.

Because of the different subtleties that now exist there is a danger that arrangements can be manipulated to achieve the same result in any case. Examples include transferring DC benefits to PRSAs which can then avail of the ARF option or treating all employee contributions as AVCs to maximise the ability to avail of an ARF.

Security of Benefit

The original logic relating to the availability of the ARF option appears to have been based on the premise that those individuals who were proactive in providing for their retirement would have the ability to manage their funds in retirement. This seemed to indicate that those whose retirement provision was arranged through an employer did not have the same ability to manage their funds in retirement. There is no real basis for these assumptions and in any case there are more effective means of ensuring that the ARF option is only availed of by individuals who do have the ability to manage their funds in retirement. Furthermore the fact that PRSA holders can avail of the option means that individuals whose employers arrange retirement provision through a PRSA have the ARF option available to them.

There is no logic in this and it is unfair to exclude DC members purely because their retirement provision has been arranged in a certain way. It is clear though that the ARF option may not suit all individuals and that, for many individuals, the certainty and security offered by an annuity may be a better option for them. Determining whether or not this is the case should be a matter of individual choice after informed advice and consideration and not by means of arbitrary assumption. If individuals need to be protected from making poor choices this can be done by strengthening the regulation of the sale of ARFs.

In addition, the provisions in relation to the specified income and the amount that must be transferred to an AMRF could be strengthened as a means of providing further protection. Indeed the IAPF has frequently argued that the €63,500 limit beyond which pensions savings can be invested in ARFs as distinct from AMRFs is too low. This amount, which has never been increased since its introduction, appears to have been originally based on the notional capital value of the State Pension at that time. In today's terms that amount would be closer to €200,000.

Furthermore, members of DC schemes are increasingly involved in tracking and managing their retirement savings. As well as receiving annual benefit statements that allow them to track their savings, many DC members now have on-line access to their individual member accounts. This allows members to track their savings on a more frequent basis and even to change the funds in which they wish to invest or the level of contributions they can make. This level of member involvement will only increase following the introduction of further disclosure regulations including the requirement to furnish members with annual benefit projections. The accumulation of savings through individual accounts makes DC savings particularly suitable for transfer to an ARF as those individuals are already familiar with the concepts of managing their savings. For that reason alone the ARF option should be available to all individuals who accrue retirement savings on a DC basis and not just to specified categories.

Indeed, this is also the reason that the IAPF believes that this option would not be appropriate for members of DB schemes (whether funded or unfunded), as there is no accumulation of savings on an individual basis. The focus of members of DB schemes is on the accumulation of a benefit and they track their pension accrual on that basis. Issues such as the cost of annuities make little real difference to those members as these will not directly impact the benefit they receive.

Risk

One of the general concerns in relation to DC provision is that the member carries all of the risk. The employer and employee commit to a given level of contributions and the amount of savings ultimately accumulated is dependent upon the investment return achieved. Generally, higher returns can be earned in investment classes that carry greater risk. As pensions are long-term investments

individuals can often afford to hold a high proportion of investments carrying more risk in order to achieve a higher return over the long term. Many individuals move larger proportions of their savings to more stable and less volatile investment classes as they move closer to retirement. While this means that those individuals are more protected from potential losses caused by a downturn in, for example the equity markets, it also means they will not benefit from any gains in those markets. While, as has been evident in recent times, equity markets can suffer severe short-term volatility they do tend to perform on a more stable and consistent basis over the longer term.

However a DC member who is approaching retirement can suffer the short term volatility but does not have the opportunity to recover as the requirement to purchase an annuity at retirement age will lock in any losses occurred. The option to transfer to an ARF would allow the individual to continue to invest on a long term basis. Therefore allowing the option to transfer to an ARF removes one of the risks a DC member is subject to, which can only be in the interest of DC members and pension provision in general. As there are currently over 250,000 active members of DC schemes and almost all new schemes being established are on a DC basis, any measures that can reduce some of the risk carried by those individuals must be welcome.

It is illogical that DC members carry risk throughout their entire working lives, in the same way as those who are able to transfer to ARFs, but are then not allowed to continue to invest in retirement. This is the primary reason that this option is only suitable for individuals who accumulate retirement savings on a DC basis. Individuals who are members of DB schemes do not carry any investment risk and therefore it would not be logical or appropriate to suddenly allow them to do so in retirement.

Higher Returns

It is clear from the Life Strategies/Indecon analysis of the Irish annuity market that, at present, annuities are only being purchased by those individuals who are forced to purchase them i.e. DC members. Those that have a choice such as DB trustees or those who can avail of ARFs, choose not to purchase annuities, largely because of the fact that they are seen as offering poor value. The certainty offered by annuities comes at a heavy price for many reasons including the cost of capital to the insurer, the relatively low return on the assets with which the insurer has to match the liability, longevity assumptions and the expenses and profit margins of the insurer.

An individual does not have any cost of capital issue and, with the appropriate appetite for risk and the ability to carry risk, can invest in different asset classes than an insurer which is largely restricted to investing in bonds. These factors allow the individual the opportunity of achieving a higher return in retirement.

Taxation

There appears to be some concern that any moves to increase the availability of ARFs will result in a reduction in the amount taxation collected through the payment of pensions. The concerns appear to relate to the fear that individuals who avail of ARFs will not take draw down on the funds and therefore escape income tax. This would represent a considerable loss to the Exchequer as it would not collect the income tax it would have expected to collect and indeed the taxation it had deferred.

This concern tends to relate to the initial experience of ARFs where drawdowns appear to have been lower than would have been expected or where no drawdowns have been made on ARFs. However, in analysing the initial experience it must be remembered that the individuals who could initially avail of an ARF were the self-employed, proprietary directors and individuals with AVCs. Many of these individuals would have the ability to use an ARF as part of estate planning rather than pension provision. Many may also be in a position not to require any income initially, as being self-employed or proprietary directors they are more likely to continue to work than they would if they were subject to a compulsory retirement age. They are also likely to be in a position to avail of financial advice which would make them aware of the benefits of ARFs, particularly as part of estate planning. Indeed, it is somewhat ironic that the only individuals allowed to transfer to an ARF were those who were least likely to need to draw down on the funds. It also makes little sense in the context of the generosity of the tax reliefs that seek to encourage individuals to save for retirement that their hands are then tied in relation to how they can invest their funds at retirement.

In any event, there are other methods available to deal with these issues such as reviewing the taxation position of ARFs that are not drawn down upon and end up being passed on following the death of the ARF holder and, as has happened, applying a deemed distribution tax. The IAPF strongly believes that it is completely unreasonable to allow the concerns about existing issues to prevent other individuals the same opportunities where there are no other logical reasons for doing so.

According to figures from the Irish Insurance Federation (IIF) contained in the Pensions Board's National Pensions Review a total of 7,815 ARFs were set up between 2000 and 2004 with IIF members and the total paid into those ARFs was €1,226,123,000 an average of €156,895 per ARF. This amount is likely to be larger than the average available to a DC member after that member has taken a tax free lump sum. For the reasons outlined earlier it is reasonable to assume that almost all annuities sold from 2000 to 2004 were in respect of members of DC schemes as the figures show a switch to ARFs from annuities from that date. A total of 6,307 annuities were sold in that period and the total premium was €574,591,000, an average of €91,104 per annuity.

Based on these figures it is unlikely that the average DC member would have the capacity to transfer to an ARF, particularly where they have no other available income and do not have the option or desire to continue working. However for those that do have the capacity the option should be available. Furthermore, for those people who do transfer to an ARF the primary reason should be that they wish to enhance their income in retirement. There may be other reasons, such as the desire to have flexibility around when they start to receive their retirement income, but the overall aim should be to enhance retirement income and thereby securing a better standard of living in retirement.

Where individuals are successful in achieving that aim the Exchequer will also gain as there will have been more income to be taxed than if the individual had purchased an annuity. Indeed, based on the historical return rates available, where equities always outperform bond and cash rates over any extended periods of time, there should always be greater revenue from ARFs than from annuity payments and therefore more tax.

Flexibility

Being able to avail of the ARF option also provides the individuals with much greater flexibility in retirement. They can choose to vary drawdowns in accordance with their own particular needs. This could aid those individuals who wish to continue working either on a full-time or part-time basis as they could choose to make no or smaller drawdowns while continuing to work. This is also consistent with stated Government policy to examine means of facilitating those who wish to have the choice to work longer. It is also consistent with the Government's plans to allow individuals to defer payment of their State Pension.

Furthermore the capital available to an individual in an ARF may be more suitable in dealing with any long term care requirements than the income from an annuity.

Death

When purchasing an annuity, the prospect of dying shortly after the annuity commences payment and effectively losing the savings accumulated to the insurer is one that individuals find difficult to accept. While individuals can use some of the accumulated savings to purchase spouse's and dependant's pensions they do see this as a big issue. Again this stems from the fact that DC members are accumulating their pot of money and find it difficult to comprehend that they can just hand that over to an insurer and that it then dies with them, irrespective of when that death takes place. With an ARF any unused balance on death can be transferred to a spouse.

Conclusion

In conclusion, the IAPF believes that ARFs should be available to DC members for the following reasons:

- Extending the ARF option to DC members creates a level playing field and it is logical and reasonable to do so as they accumulate retirement saving in the same way as the categories of individuals who currently have access to ARFs. The current rules on eligibility for ARFs can dictate or influence the choices individuals and employers make regarding the type and

format of retirement provision when there are much more important and fundamental factors that should be considered

- The risk taken by DC members and the nature of accumulation of DC funds are the reasons that this option should only apply to funds accumulated in that way and why the ARF option is not appropriate for DB members. DB members do not take investment risk and accumulate benefits rather than funds
- Any concerns relating to individuals not properly managing their ARF can be dealt with by regulation of the sales process and by increasing the income or funds individuals must have available before they can avail of the option
- Allowing the option to avail of an ARF removes the timing risks associated with compulsory annuitisation. It also ensures that individuals who have carried risk throughout their working lives are not prevented from continuing to invest in retirement
- Transferring to an ARF allows individuals the opportunity to achieve higher returns on their funds in retirement
- Where higher returns are achieved there should be an increase in the overall tax collected on retirement income. Any taxation issues that exist on ARFs should be dealt with by taxation measures and not by exclusion
- The ARF option facilitates those who wish to defer or phase their retirement from the workforce
- It removes the concern that DC members have of losing their accumulated savings to the annuity provider should they die shortly after commencement of the annuity

APPENDIX 3

IAPF Services Sector Pension Survey

APPENDIX 4

Discussion Document

THE ADVANTAGES OF A STATE BACKED ANNUITY PURCHASE SCHEME IN THE CONTEXT OF THE CURRENT FUNDING STANDARD

MAY 2005

HEADLINE ADVANTAGES

Prevents excess resources being diverted to pension funds which hurts plan sponsor competitiveness	Allows for an efficient use of scheme resources in an involuntary wind-up	Prevents excess resources being diverted to pension funds which reduces immediate tax revenue
Prevents unnecessary allocation of total pensions spend towards DB to the detriment of DC	Reduces Exchequer difficulties in event of removal of Funding Standard derogation for Semi-State sector	Prevents build up of non refundable and unnecessary scheme surpluses in line with Revenue Guidance

HEADLINE DISADVANTAGE

Increases the State's Investment/Mortality Risk

Reality: The State currently manages an enormous pensions payroll (State Pensions and Public Service Pensions) and has underlying obligations in respect of funded pensions (which on their own are of equivalent size to the private sector e.g. Semi-State and Universities Sectors etc). The proportion of private sector pension funds which can be expected to enter an involuntary, insolvent wind-up is not in itself significant. The liabilities assumed by a State Annuity Fund would therefore be miniscule when put in context particularly as this proposal provides for those liabilities to be funded on a long term economic cost basis. Accordingly, we are confident that the proposal outlined in this paper would not add any material additional investment or mortality risk to the State.

BACKGROUND

The Irish Association of Pension Funds proposed, in its response to the Pensions Board Consultation Document on the Review of the Funding Standard, that the establishment of a State backed annuity scheme would enable the Minister to ease the impact of the Funding Standard on the competitiveness of sponsoring companies without any material weakening of the security of members of defined benefit schemes.

The relevant extract from the IAPF response is attached at Appendix 1.

IAPF believe that this is necessary as the application of the current Funding Standard is having the effects outlined below which are extremely detrimental to the interests of pension scheme members which the Standard was designed to protect.

IAPF now believe these effects to be widespread and that the matter requires urgent consideration.

IAPF is also very concerned that the derogation from the funding standard enjoyed by state sponsored bodies may not be allowed to continue consequent upon EU Directives. If it is correct that (following the IORPs Directive) the schemes of State sponsored bodies can only continue to enjoy derogation from the funding standard provided the underlying benefits are guaranteed by the State then the extent of any State guarantee for such underlying benefits will have to be confirmed.

If these state sponsored bodies are required to meet the current funding standard the rate of State funding for these bodies will come under enormous and immediate strain and will impact upon the State's capacity to develop national infrastructure projects and health, social and educational policies.

The table below shows an extract from the Pensions Board Annual Report 2003 recording the number of schemes (and scheme members) currently impacted by the Funding Standard and also the number of schemes (and scheme members) who currently enjoy derogation from the Funding Standard i.e. State Sponsored Schemes.

	No. of Schemes 31.12.2003	No. of Members 31.12.2003
Subject to the Funding Standard	1,541	230,685
Excluded from the Funding Standard	85	249,735

IAPF points out that the continuation of the current Funding Standard without the introduction of a State Annuity Fund, unnecessarily increases the contributions payable to pension funds which depresses short term tax revenue.

The effects of the current funding standard are:

- a) Schemes which pay pensions from scheme assets (as opposed to buying annuities) are nevertheless required by the current funding standard to seek contributions from their sponsoring employers that target funding on the significantly more expensive annuity purchase basis even though annuities will never be purchased. This has a number of effects:
 - i) It results, in many cases, in a statutory requirement to fund pension schemes at a higher level than deemed necessary by independent actuaries.
 - ii) This excessive funding inhibits national competitiveness, development and growth by requiring an inefficient use of capital (this applies particularly to utility companies, banks, semi-state, educational and institutional bodies);
 - iii) It serves to accelerate the decline of defined benefit pension provision as employers realise that the excessive funding required to satisfy the current Funding Standard does not generate employee appreciation compatible with the cost.
 - iv) The excessive funding will only be released into scheme surplus as pensioners die – this can mean tying up funds needlessly for over twenty years, or, where scheme rules prevent refund of surpluses - forever.

Illustration

When a pension scheme matures and all remaining liabilities are pensioner liabilities the current funding standard requires that it hold sufficient assets to buy annuities for all those liabilities.

Due to the inflated expense of annuity purchase the logical policy for a stable pool of liabilities would be to pay pensions from scheme assets. This would result in an expected funding requirement (actuarially calculated to reflect the expected cost of paying those pensions) of a significantly smaller amount than the actual amount required by the funding standard to be reserved. This will result in a surplus within the pension trust which, due to restrictions on refunds of surpluses and extensive powers of augmentation, may be irrecoverable by many employers.

It is of little comfort to employers that the funds may be released, if at all, over such a lengthy time horizon when companies are forced to be competitive in their marketplaces over the short term.

Furthermore, the nature of the Irish trust model is such that in many of the affected pension schemes the sponsoring employers may ultimately be denied any benefit from the surplus monies unnecessarily generated.

- v) Tax revenues in the short term are depressed as the excessive contributions payable to support the Funding Standard are relieved against personal or corporation taxes as appropriate.

- b) Some employers are being forced to reduce benefits for existing and new members of their schemes.
- c) Some employers are being forced to close their defined benefit schemes to new entrants. These schemes are typically being replaced for new entrants by defined contribution schemes with poorer benefit design.
 - } In the cases of c) and d), the
 - } overall private sector pension
 - } provision is reduced which may
 - } in future years create pressure
 - } for the State to increase State
 - } pension benefits to make up for
- d) Some employers are being forced to wind-up their defined benefit schemes and provide future pension benefit accrual on a less generous defined contribution basis.
 - } the decline in private sector
 - } provision.

PENSIONS BOARD VIEWPOINT

The Pensions Board report, in December 2004, to the Minister for Social and Family Affairs on its Review of the Funding Standard stated:

“... the Board recommends that the introduction of a State Annuity Fund be explored thoroughly. There was some support for the view that the implementation of such a fund would cause the benchmark annuity cost for option A (the funding standard) to be reduced. The severity of the Funding Standard would thereby be eased for schemes generally without reducing the security of scheme members.”

{emphasis added}

and,

“If a State Annuity Fund is not implemented, the Board agrees that a further review of the Funding Standard may be required in light of experience in the meantime.”

The difficulty with this position is that experience in the meantime will be the closure and wind-up of schemes and the reduction of benefits for scheme members.

IAPF do not believe that we have the luxury to react after the event when experience proves that this funding standard was too severe and was detrimental to members whose interests it is seeking to protect.

The Pensions Board Report considered some of the perceived advantages and disadvantages of a State Annuity Fund and for ease of reference the relevant extract is set out at Appendix 2. Summary views of the IAPF in respect of these advantages and disadvantages are set out in Appendix 3.

THE ANNUITY MARKET

There are significant structural difficulties in the annuity market at present which underpin the importance of having a State Annuity Fund:

- a) At present there is limited capacity in the annuity market with only a small number of insurers willing to provide annuities and their capacity to meet any significant demand very limited. As such, if the necessity arose to secure a significant amount of pension liabilities by annuity purchase (say because of the wind-up of a large pension scheme) it is questionable as to whether supply would be sufficient to meet demand.
- b) In addition, there is even less supply available for index linked annuities leading to significant concerns as to availability and price if demand arose. As such, the logic of protecting security by setting funding standards at rates available for individual annuity purchases seems to ignore the realities of the marketplace.
- c) Due to the small number of annuity providers in the marketplace, and their apparent low appetite for trade, the market is seen to be relatively uncompetitive and consequently product pricing is expensive.

This low appetite is evidenced by the manner in which insurers vary their annuity rates from time to time to satisfy a calculated and finite acquisition of risk. This mechanism seems to be used by insurers to deliberately make their quotations uncompetitive once periodic appetites are satisfied and competitive again once their appetite recurs.

- d) Due to the nature of their business, insurers are conservative in the manner in which they reserve against their liabilities. Accordingly, mortality assumptions adopted by insurers when quoting for annuity purchases can be excessively cautious as the insurers build in margins for further improvements in mortality and their selection assumptions can be excessively cautious to allow for anti-selection by healthier prospective annuitants.
- e) As annuity costs are closely correlated to returns on long bonds current interest rates, at historically low levels, have made annuity purchase significantly more expensive than any time in the past. It is difficult for insurers to make allowance for future improvements in long bond interest rates due to the regulatory environment within which they are required to operate.
- f) Insurers will include a margin within the annuity cost quoted for the cost of capital that they are required to reserve against their annuity liabilities which might otherwise be used to generate profits within other business operations.
- g) Naturally, insurers will include a margin within the annuity cost quoted for profit and administration expenses and it is difficult to identify whether these margins are competitive or efficient from the perspective of the annuity purchaser.

The differences between the cost of an annuity and an independent actuarial best estimate assessment of the cost of a particular pension over the long-term assuming investment in a mix of assets is summarised below.

There are two types of difference

Margins	Excess return from investing in long-term assets
<ul style="list-style-type: none"> • Insurance companies will assume conservative mortality (not expected mortality) • Insurance companies will allow for expenses/profit/contingency margins • Insurance companies will seek recompense for the capital utilised to write annuity business 	<ul style="list-style-type: none"> • Insurance companies invest in bonds. Traditionally, pension funds have invested in a broad range of assets to generate a higher return than bonds. The State Annuity Fund could invest in a range of assets. • 50% equities; 30% bonds; 15% property and 5% cash would conservatively increase the expected return available by 1.67% p.a.

Over the long-term (100 years), even allowing for the very poor returns of the 2000-2003 period, equities have generated a return of 4% in excess of bonds. We do not believe that it would be prudent to assume that the scale of excess return from equities will be repeated. However, conservatively, most analysts agree that over the long term equities will achieve a return of 3% in excess of bonds, property will perhaps 1½% in excess of bonds and cash in the region of 1% below bonds.

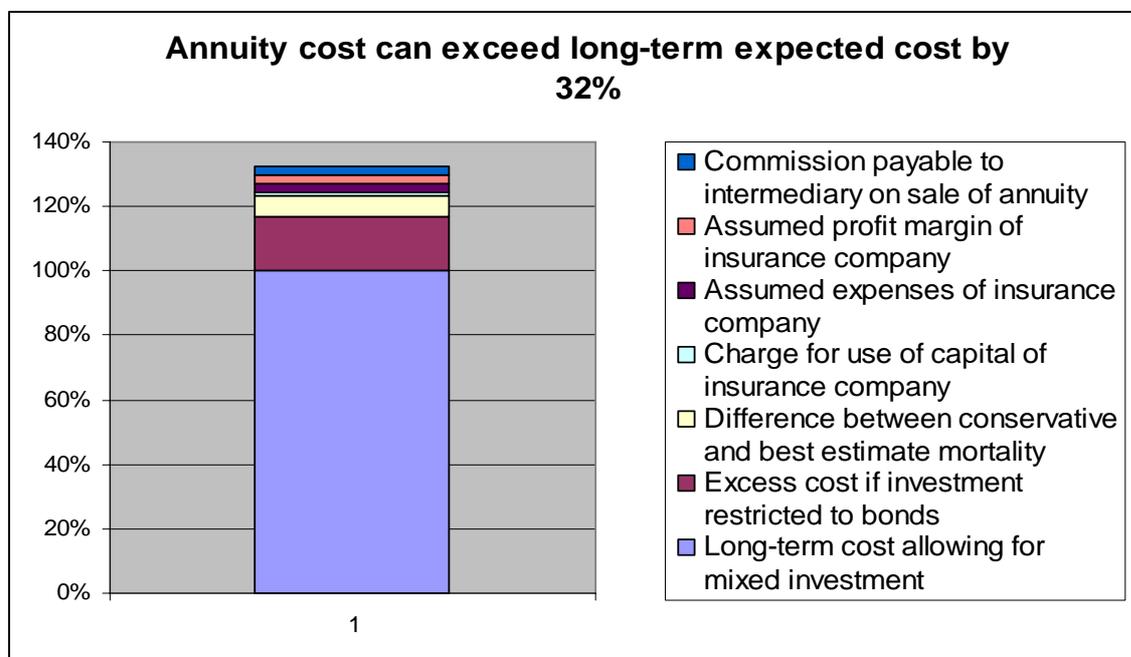
A Barclays Capital survey of UK returns shows the following real returns up to 31.12.2003 (i.e. returns in excess of inflation, annualised). The UK cycle of interest rates is somewhat out of sync with the Eurozone so the short-term returns will differ materially but we believe that the long-term lessons are valid.

	2003	10 year return	20 year return	50 year return	100 year return
Equities	16.9%	3.2%	8.0%	6.9%	5.1%
Government bonds	-1.2%	4.6%	6.1%	1.6%	1.1%
Corporate bonds	6.7%	6.7%			
Index linked	3.9%	3.7%	3.9%		
Cash	0.9%	3.1%	4.4%	1.8%	1.0%

Allowing for the asset distribution suggested above, a State Annuity Fund could be expected to produce a return of 5.67% versus bond returns of 4%.

This would mean that a State Annuity Fund could provide for pensions in specified circumstances at a cost well below the cost of buying annuities. For each long term cost of €100, the cost of buying an annuity is in the region of €132 and the differences are outlined in the graph below.

While we are not privy to the exact pricing parameters of insurance companies, and therefore the figures underlying this table cannot be taken as completely accurate, we are convinced of the broad validity of this analysis.



Long-term cost allowing for mixed investment	€100.00
Excess cost if investment restricted to bonds	€17.07
Difference between conservative and best estimate mortality	€6.05
Charge for use of capital of insurance company	€1.32
Assumed expenses of insurance company	€2.65
Assumed profit margin of insurance company	€2.65
Commission payable to intermediary on sale of annuity	<u>€2.65</u>
Total cost of annuity	€132.38

We would emphasize that the bulk of the difference between the expected cost of providing for pensions and the annuity cost is caused by the requirement of insurance companies to invest in bonds and their use of a higher level of mortality improvement than expected by independent actuaries (conservative vs. best estimate).

We have no evidence that annuity providers over charge for this type of product.³⁰

³⁰ The prohibitively high cost of purchasing annuities is one of the principal reasons why the IAPF support the extension of the ARF/AMRF option to all defined contribution members. For defined contribution members the requirement to purchase an annuity at retirement also represents economically inefficient use of capital. When the investment period post retirement may be as long as the pre retirement investment period it is anomalous that pre retirement investment tends to be predominantly in equities and property where as in retirement there is a requirement that all of the investment must be in fixed interest investments.

STATE ANNUITY FUND

A State Annuity Fund can replace open market annuity purchase much more efficiently and cheaply than the open market for many reasons as illustrated by the tables produced above.

However, the most significant support for a State Annuity Fund lies in the fact that the monies paid to a State Annuity Fund in consideration of each annuity can be invested more freely by the Fund than they could otherwise be invested by an insurer providing an annuity in the open market. Accordingly, a State Annuity Fund could provide the same pension as an insurer but require substantially less money from the prospective annuitant to do so.

Insurers are led by regulation, designed to protect annuitants against the insolvency of the insurer, to holding conservatively calculated reserves and to closely match annuitant liabilities by holding fixed interest assets of similar duration.

A State Annuity Fund would not be so limited and could develop investment strategies designed to meet its liabilities over the long term. This would enable a State Annuity Fund to invest in a mix of assets including real assets which can be expected to produce significantly greater returns than fixed interest assets of matching duration.

If one assumes a return premium of 1.67% over fixed interest returns for a conservatively diversified investment strategy that might be adopted by a State Annuity Fund then one could expect the cost of an annuity to fall by approximately 17% based on this factor alone.

OPTION TO CONTRIBUTE ON ONGOING BASIS IF EMPLOYER ACKNOWLEDGES PENSION DEBT

The IAPF have long argued that the only realistically affordable way of supporting the defined benefit system as we know it is to establish an ongoing funding test as the statutory benchmark. The current funding standard differs from this approach principally because of the increased cost of funding for annuity purchase over the cost of funding for pensioner liabilities on an ongoing basis.

IAPF note and understand the reluctance of the State to weaken the current funding standard and believe this to be based on a presumption that to do so would reduce member security.

IAPF argue the reality to be that failure to complement the current funding standard with an option to fund on an ongoing basis will be enormously detrimental to many members of defined benefit schemes who will find their schemes wound-up or their benefits reduced as a result.

IAPF believe that member security can be maintained and member benefits protected (simultaneously) by complementing the current funding standard with an option for employers to elect an ongoing funding standard (with trustee and Pensions Board consent) if on doing so they also accept an obligation to fund the difference between those funding levels from employer assets in the event that the pension scheme is ever wound up in deficit.

Thus in circumstances where a scheme is wound up in deficit by a solvent employer the employer will become responsible to fund the difference between the ongoing valuation of liabilities and the current funding standard valuation of liabilities if the employer opted for the ongoing funding standard as the schemes statutory benchmark. In this fashion, the security of members provided by the current funding standard is not lost on insolvent wind-up in such circumstances.

One could argue that member security would be enhanced in such circumstances as the severity of the current funding standard has forced the Pensions Board to allow significant extensions of time for employers to restore funding standard solvency. This means that where member security is threatened by investment performance or market conditions the current standard and the current approach to its enforcement leaves members exposed to scheme deficits for extended periods. In an environment where an ongoing funding standard is available to complement a discontinuance funding standard greater investment freedom can be enjoyed by scheme sponsors, and if elected by an employer, security of member benefits can be restored more quickly.

Of course if the sponsoring employer is also insolvent at a time when its pension scheme, funded on an ongoing basis, winds up in deficit then there may be insufficient employer assets available to make up the discontinuance deficit. It is in these circumstances that the State Annuity Fund would be required to accept assets from the pension scheme and provide annuities to the schemes pensioners in return.

The value of assets transferred to the State Annuity Fund would be calculated on an ongoing basis (as defined by the Society of Actuaries in Ireland in consultation with the State Annuity Fund) to match the cost to the State Annuity Fund of providing the annuities for the schemes pensioners.

This would result in a significant increase in the assets available to discharge the liabilities of active and deferred members of the scheme and may be of sufficient assistance to allow those benefits be discharged in full (where the scheme was solvent on an ongoing basis at the point of wind-up). Where there is an insufficiency of assets available to meet liabilities for active and deferred members those benefits would be scaled back as under the current regime.

An employer electing to adopt the complementary funding standard proposed by the IAPF under this arrangement would not be required, under these proposals, to fund excessively for an annuity purchase which it would not ultimately require and some of the negative effects of the current funding standard set out on pages 2 and 3 of this paper may be avoided.

APPENDIX 1

Extract from IAPF Response to the Consultation Document on the Review of the Funding Standard (September 2004)

2.8 State backed annuity purchase scheme

The IAPF believe that there is merit in the State providing a vehicle to take on, in rare incidences, pensioner liabilities in return for the payment of a capital amount based on the actuarial value of such benefits on an ongoing basis.

A State backed annuity purchase scheme would enable the Board propose an advance funding system on a discontinuance basis but with the flexibility to allow employers elect (with trustee and Pensions Board consent where the best interests of the members dictate) an ongoing funding approach with additional security such as a voluntary lien on employer assets.

The State backed scheme would then provide an additional safety net in instances where involuntary insolvent wind-ups occur and where the employer has insufficient assets to satisfy the difference in assets between the ongoing liability in respect of pensioners and the annuity cost for such purchase.

Under this framework the State could agree to accept assets at the ongoing valuation rate in exchange for the payment of the pension to the member and this would allow the State at a no cost basis to provide the protection necessary in order to underpin the defined benefit system.

In this environment it would also be possible to envisage that in insolvent wind up pensioners could be offered the option of transferring their benefits to an ARF at the actuarial valuation or ongoing value of those liabilities rather than the annuity cost. This may well suit some pensioners and would also relieve the position regarding the funding of deferred members and active employees.

It is probable that the system, in such circumstances, would have to also be amended to allow ARF options for pensioners on solvent wind up to ensure that the range of options available for members of an insolvent wind up is freely available to all, i.e., that pensioners on insolvent wind up are not preferred.

The advantages of a proposal in this regard are to allow employers to elect to fund schemes on an ongoing basis. In return, it is proposed that employers' commitment to continue to fund such schemes is underpinned by a voluntary assumption by the corporate entity of a "lien on employer assets". This lien would apply in circumstances where the scheme is subsequently wound up and has insufficient assets to secure annuities for pensioner liabilities.

In addition the current funding standard framework would not require a significant alteration as the existing funding standard would remain in place and an ongoing funding standard would merely be an option for the trustee / employer election subject to Pensions Board consent under Section 49(3).

The establishment of a State backed annuity purchase scheme can be supported by the following arguments.

- It will only apply in the event of involuntary insolvent wind-ups (i.e., where the employer has gone into liquidation) and where there are insufficient corporate assets to satisfy the "lien on employer assets". The incidence of such events could reasonably be expected to be low.
- It would not necessarily require any substantial State funding and therefore as an alternative to a pension protection fund, avoid the imposition of levies on either the taxpayer or the pensions system.

- It would operate on a basis where, on the insolvent liquidation of a sponsoring employer, an insolvent scheme would transfer to a State backed fund the actuarial equivalent (calculated on an ongoing basis) of the pensioner liability.
- The fund could be invested on an ongoing basis with an equity/bond mix and should not be subject to EU Life Directive regulations or IORP's investment principles. As such the fund ought to be able over the long term to satisfy the pension liabilities from the assets paid into the fund.
- The incidences of involuntary insolvent wind-ups are unlikely to be materially significant (in terms of the number of such occurrences arising).
- There are numerous third party administrators who would be willing to operate a pensions payroll system, thus eliminating any administrative burden on the State.
- Costs associated with this administration would be included in the actuarial basis for determining the costs of benefits.
- Equally, the investment of the fund's assets could be managed by private sector trustee and investment manager appointments to further eliminate administrative burden on the State, or otherwise by the NTMA using the NPRF. Costs associated with this operation and investment management fees would be included in the actuarial basis for determining the costs of benefits.
- The existence of such a scheme may be seen to prefer members of defined benefit schemes. As such, it may be appropriate to simultaneously recommend the extension of the ARF regime to all defined contribution members.

APPENDIX 2

Extract from Pensions Board Review of the Funding Standard – Report to the Minister for Social and Family Affairs (December 2004)

7.38 Arguments in favour of a State Annuity Fund include:

- (a) The benefits of such a fund would be that it would not incur the margins that commercial insurers include on their charges. The savings could potentially arise from a number of sources:
 - (i) Although the fund charges would include appropriate allowance for administration costs, there would be no margins for profit or solvency or other contingencies.
 - (ii) The mortality rates assumed by the fund might be less cautious than a commercial insurer, as the fund would only be seeking to break-even.
- (b) Although such a fund would only be available to schemes that are wound up, the existence of the fund would allow the Funding Standard for pensioners to be lowered. The standard would be based not on the commercial insurance cost, but on the charge made by the fund in the event of a wind-up; and
- (c) It is noted that the State bears a considerable longevity risk in respect of Social Welfare and public service pensions, so that the real additional quantum of risk represented by an annuity fund as described would not be significant.

7.39 Arguments against a State Annuity Fund include:

- (a) In the absence of any detailed examination of the subject, it remains to be proven that pensioner insurance would be provided at less cost by the State Annuity Fund than by commercial insurers. Annuity prices reflect low interest rates and greater longevity and the State cannot hope to avoid the impact of such developments. In addition, if the State were to establish such a Fund, the Fund would have to take responsibility for the payment of pensioners out into the future and, inevitably, it would have to incur real extra costs in acquiring pensions-related expertise hitherto confined to the private sector;
- (b) Being operated under the auspices of the State, it would be unrealistic to assume that the Fund would not be subject to intense pressure to pay pension increases (even where they were not guaranteed under the original scheme) and to make good shortfalls in pension funds of companies involuntarily wound up. It would be exceedingly difficult for such pressure to be resisted;
- (c) It should not be assumed that the Fund could be confined to members of defined benefit schemes connected with involuntarily-wound up companies, especially if the members involved were found to be in a more favourable position than members of other DB schemes, let alone, of course, members of DC schemes and PRSA holders. Demands for parity of protection from the State against the vagaries of the pension marketplace (involving some form of State guarantee, perhaps) would be inevitable and, on grounds of equity, could well be difficult to resist, at potentially very substantial cost to the Exchequer. In addition, State involvement in the annuities business, through the Fund, could well be mirrored by a corresponding disengagement on the private sector's part over time, on the basis of the latter's perception that the State would play an ever-increasing part in the area. This would have substantive consequences for both the State and the pensions industry generally;
- (d) The contention that the real additional quantum of risk represented by an Annuity Fund would not be significant requires to be proven. Already, the cost to the State of a partial pre-funding of social welfare and public service pensions is extremely significant at 1% of GNP per annum, i.e. about 10% of social welfare expenditure at present. The cost to the State of an Annuity Fund, even on the scale envisaged by its proponents, let alone any

extensions on the lines suggested in paragraph 7.38, could only be a tangible addition to the burden already borne by the Exchequer; and

- (e) There is concern that the expedient of establishing a State Annuity Fund is being proposed in the comparatively narrow context of devising a viable Funding Standard for defined benefit schemes. Insufficient regard is being paid to the possible consequences for the wider pensions area, for example, or the Exchequer, which through very sizeable tax foregone on an annual basis (estimated to be of the order of at least €2.5 billion at present), already provides a very significant degree of support for the sector. All the implications of the initiative would need to be explored fully before a proposal for action were submitted for approval to relevant Departments, the Government and the Oireachtas.

APPENDIX 3

Summary views of the IAPF in respect of the advantages and disadvantages listed by the Pensions Board in their report to the Minister extracted in Appendix 2

Arguments in favour of a State Annuity Fund

IAPF agrees fully with the arguments set out in section 7.38 of the Pensions Board report as extracted at the start of Appendix 2 and believes that the asset allocation flexibility which a State Annuity Fund can adopt provides further significant advantage.

Arguments against a State Annuity Fund

- 7.39 (a) The main argument here is that there is no evidence that the State could out guess the market price of annuities. IAPF would point out that the State imposes onerous solvency requirements on insurance companies which require them to price guaranteed annuity products cautiously and to invest cautiously. In the context of a private insurance company guaranteeing a future income to an individual, this is clearly a desirable approach but IAPF is convinced that in limited circumstances the State could offer superior value by pricing on a best-estimate rather than conservative basis and by investing to achieve the superior long term returns available from assets other than guaranteed assets (which insurance companies are required to invest in for solvency purposes).

The second point made is that the State would incur expense in acquiring additional expertise to manage a State Annuity Fund. However, it is likely that much of the resource necessary is already available through the NTMA and its services to the NPRF. Additional administrative costs required could be costed into the valuation basis for the pension liabilities assumed and thus ensure that the annuity operates on a financially neutral basis. Efficiencies of group administration will reduce these costs in any event. Even if the administration costs were not factored into the annuity price, IAPF feels that the costs associated with acquiring this expertise should be viewed against the costs of not acting i.e. that the existing defined benefit market will contract significantly unless action along these lines is taken.

- (b) IAPF believes that pressure to pay benefits which are not supported from funds available can be resisted by two simple rules – (i) the fund will only take on a pension on a financially neutral basis and if insufficient funds are available the pension will be scaled back and (ii) the fund will only pay benefits in line with the original benefit promise and therefore no discretionary decisions will be made by the administrators of the fund.
- (c) IAPF agrees that pressure could emerge for the extension of the State Annuity Fund to situations where there is not an involuntary wind-up of the scheme, and that the implications of any future potential policy change would need to be understood in advance.

IAPF believe that the extension of the ARF regime to members of all defined contribution schemes would reduce pressures on the State Annuity Fund to extend beyond its initial remit as those members would then have the same access to long term investment returns which would be supporting the benefits payable to annuitants under the State Annuity Fund.

- (d) IAPF view the State Annuity Fund, in the manner described (which differs materially from the more open protection schemes of other countries), as financially neutral by definition – each new pension established would be supported by a fund of equal value. If a scheme winds up with insufficient assets to back the pensions promised, the scheme promises would be scaled back to match the funds available.
- (e) IAPF wholly rejects the argument that the State Annuity Fund would prove a drain on the Exchequer. The establishment of the State Annuity Fund would reduce the level of

funding required for pension schemes at this stage – this would lower the level of relief (deferral of tax) claimed by pension schemes.

Therefore, over the short-term, the establishment of the State Annuity Fund would improve the Exchequer's position.

Effectively, the distribution of contributions paid (and hence tax relief claimed) over the short and long term would be more balanced if the State Annuity Fund was established. This is crudely illustrated in the graph below.

Illustration of higher contributions required and hence higher tax relief claimed in the case of a scheme with a 10 year funding proposal

