iapf
the voice of Irish pensions

SUBMISSION

NATIONAL PENSIONS REVIEW

Submission from the Irish Association of Pension Funds

September 2005

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The main Report contains the following Sections and Appendices:

National Pensions Review 2005

Submission of the Irish Association of Pension Funds

The Irish Association of Pension Funds (IAPF) has prepared this submission as part of the National Pensions Review with a view to making constructive observations which the IAPF believe will be useful to the Pensions Board and the Minister and his officials in relation to the development of pension policy in Ireland.

The IAPF's preferred position is to incentivise voluntary Second Pillar provision to supplement the existing mandatory State pension.

Our submission covers the views of the IAPF in the following key policy areas:

- Pension adequacy and avoiding poverty in retirement;
- Increasing meaningful pension coverage amongst the working population;
- The taxation system;
- Protecting the valuable level of retirement benefits accumulated to date.

A State backed annuity scheme

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 ease the Funding Standard without any material weakening of the security of members of defined benefit schemes.

This topic has been included in the terms of reference for the National Pensions Review and due to the relevant importance of the issue we have issued a separate paper on the topic rather than cover it within this document.

Research commissioned

We also commissioned a research paper from Shane Whelan of UCD entitled "A Discussion of Principles to Guide Pension Provision in Ireland for the 21st Century" to further the debate on our National pensions policy. Whilst the report does not represent the formal view of the IAPF, we are in broad agreement with many of the aspects of the paper and look forward to discussing the detail of the research paper with you.

Role of the State

The IAPF fundamentally believes that:

- The State should provide, directly through the PRSI funded State pension system, an adequate basic income for all individuals who have been employed in the country.

- The State should facilitate and continue to encourage supplementary pension provision on a voluntary basis.

On this basis, the IAPF would be broadly supportive of an improvement to the current State pension to look after those who cannot afford to make any further pension provision combined with a simplification of the taxation and regulatory regimes for group pension schemes.

The IAPF supports the target level for the State pension (single persons rate) of 34% of National Industrial Earnings as envisaged by the National Pensions Policy Initiative. The IAPF believes that this rate should also apply to social assistance pensions and that the level should be maintained in line with National Industrial Earnings through legislative changes each year under the Social Welfare Acts.

Replacement ratio and coverage targets

The IAPF believes that the objective of the National Pension System should be to assist individuals to maintain their pre retirement standard of living. On this basis, the level of adequate retirement income post retirement should be measured by reference to gross retirement income from all sources compared to gross pre retirement income from all sources.

In relation to the target originally established under the National Pensions Policy Initiative, IAPF believe that the target replacement rate of 50% is adequate.

In general, the design of defined benefit pension schemes results in an adequate level of retirement income for members. However, the increase in numbers of employees covered by defined contribution schemes over the last 15 years raises the question of whether the contributions being made into such schemes are likely to result in an adequate pension at retirement. From surveys carried out by the IAPF and elsewhere, it would appear that the level of pension contributions in defined contribution schemes is not at a sufficiently high level to result in an adequate retirement income and the IAPF has issued a report on this topic, Defined Contribution Adequacy.

Recognising that those on lower income levels will find it difficult to set aside significant savings for medium or long term objectives, the IAPF believes that the State pension should be of a sufficient level to ensure that this group achieves this target replacement rate.

For those in the middle income bracket, the IAPF supports the incentivisation of pension savings through appropriately targeted tax reliefs.

As regards the continued appropriateness (or otherwise) of a target coverage of 70% of workforce aged 30 to 65, the IAPF believes that it is difficult to set specific goals for either the extent or the adequacy of pension coverage since there are a number of ways of making provision other than through formal pension plans. The IAPF also believes that it is dangerous to focus solely on the issue of the numbers of individuals covered by pension schemes and lose sight of the need for such individuals to accumulate an adequate level of retirement savings.

Analysing the gap in coverage

The IAPF would recommend that detailed and up to date surveys on current and projected retirement incomes should be undertaken and recommend detailed examination of CSO, Revenue Commissioners and ESRI data to identify where the gaps in coverage and adequacy are to be found currently and where they are likely to be found in the future. For example, a view is commonly held that the following groups may have low coverage (this may also be further complicated by the fact that some of these groups may not have a sufficient tax incentive or desire to commence retirement savings)

- migrant workers – perhaps those who see themselves working in Ireland for a short term or who are focused on accumulating sufficient cash to repatriate home;

- employees on low pay who may only just be in the tax net – the deferral of tax argument is unlikely to be particularly strong (individuals on the basic wage could expect to get 50% of income in retirement from the State Pension),

- new entrants to the workforce, particularly at younger ages, who might be more focused on saving to purchase a house/apartment or of meeting monthly mortgage payments;

- individuals who work part time, again due to the lack of a tax incentive,

- farmers/land and property owners (and small business owners) who envisage the accumulation of such assets as their retirement savings and will have more of a financial preference to reinvest surplus cash in the growth of their business/livelihood

Level of pensions coverage

The IAPF's submission under the National Pensions Policy Initiative in 1997 estimated that coverage would rise from 52% in 1995 to 59% by 2006 and then to 62% in 2011. This appears to be in line with the current position as measured by the ESRI and Pensions Board surveys. The IAPF would comment that:

- in an era where SSIAs and mortgage repayments have been the first call for many within the middle income workforce, this group may well have found it difficult to increase pension saving;

- PRSAs should be given some additional time to ensure all employers are compliant and that additional marketing can be completed;

- we should not seek to find a one size fits all solution. SSIA take up was low amongst the low paid where pensions coverage is low – this suggests an affordability issue.

Coverage by industry

The ESRI Quarterly National Householder Survey Q1 2004 suggested that the level of pension coverage in areas such as catering and agriculture was low (12.5% and 15.8%) and the IAPF believes this is for the reasons outlined earlier (migrant workers, income levels and accumulation of other assets). Similar coverage percentages are seen in the UK, by reference to pay levels, employer size and industry.

Given the low level of coverage in some sectors, the IAPF believe that industry wide schemes, which are properly structured, managed and supported by the Social Partners, could play a role in effectively increasing coverage. This has been a positive factor within some industries, e.g. the construction industry. The issue about ensuring compliance between all operators in an industry could be agreed between the Social Partners.

Taxation

In order to incentivise additional contributions from the key low and middle income low coverage groups, the IAPF would suggest that those on the basic rate of income tax be entitled to claim income tax relief on pension contributions at the higher rate.

The IAPF would not wish to see a dilution of the existing tax regime, which has supported the valuable level of retirement provision set aside by its members. In addition, excessive change in the tax regime over a short timescale could weaken the confidence in the stability of the tax system thereby reducing the commitment of scheme sponsors and members to long term savings.

Additional measures which the IAPF would support in simplifying the current regime include:

Revenue limits

- The maximum approvable benefits under approved pension schemes should be calculated by reference to the total period as a PRSI contributor, rather than carry out calculations for each period of service separately.

Flexible retirement

- It should be possible to retire, or partially retire, at any time between 60 and 70 on the maximum approvable benefits.

Transferability of pensions

- There should be no restrictions on transfers between defined contribution schemes, RACs, DC Buy Out Bonds and PRSAs.

PRSAs

- The regime around PRSAs should be simplified to enable easier access and also potentially encourage new providers into the marketplace.

Taxation of benefits for non marital adult dependants

- Provision should be made to cover the appropriate taxation of benefits in circumstances of transfer following death to non-marital adult dependants (other than children).

There are quite a number of other areas where the current regime could be further simplified and we would welcome the opportunity to discuss these with you.

The IAPF believes that the Government's overall policy towards tax reliefs should provide the highest incentives to areas where monies are set aside for long term social and policy objectives such as pension savings. The incentives granted in recent years under various tax incentive schemes, SSIAs etc has in our view contributed to the disappointing level of take up of PRSAs and other pension savings.

Approved Retirement Funds

IAPF recommend that the ARF (Approved Retirement Fund) and AMRF (Approved Minimum Retirement Fund) retirement options be extended to Defined Contribution (DC) schemes. This would assist the attractiveness of pension funding in such schemes and complement the wider agenda of increasing pension coverage for all.

IAPF recognises the merit in providing for the establishment of an AMRF where an individual does not have a minimum guaranteed retirement income of €12,700 per annum. However, the IAPF believes that the minimum income requirement of €12,700 per annum is pitched at a very low level and makes no allowance for the increase in earnings or the cost of living since its introduction in 1999. The IAPF recommends that this figure could be increased to, say, €18,000 and linked to inflation thereafter.

It is also of considerable concern to the IAPF that the alternative to the minimum income requirement is a minimum capital requirement of €63,500 (which is again not linked to inflation). Such a capital amount is wholly inadequate to meet the minimum income objective for any individual aged less than 65 years without an immediate entitlement to a State pension. The IAPF recommends that the minimum capital requirement could be increased to, say, €85,000 and linked to inflation thereafter.

IAPF recommends that if an ARF and AMRF is set up and the holder subsequently meets the guaranteed minimum retirement income hurdle due (for example, due to a pension coming into payment), it should be possible for the holder to immediately change the status of the AMRF to an ARF.

The IAPF believes that additional financial education and awareness will be required in the event of widening the availability of ARFs.

The IAPF would support the extension of the availability of ARFs to retired members of Defined Benefit schemes in the case of wind ups.

Impact of changes on existing provision

The IAPF represents pension scheme trustees and sponsors who have endeavoured to date to promote pensions within their constituencies and good pension scheme governance. The IAPF would not want to see changes to the existing system which might deteriorate the quality of retirement savings made by individuals who have been prudent to date in setting aside assets for their retirement.

The IAPF would caution that care should be taken in introducing any changes to the existing system of taxation and benefit limits under occupational pension schemes and that sufficient grandfathering provisions be included in any such changes.

In many cases, the level of benefits under existing defined benefit pension schemes (both public and private sector) is integrated with the State Pension. A large increase in the State Pension could have the effect of “cannibalising” or shifting the pension promise for existing members from the private sector to the State without increasing the overall level of retirement benefits provided in the country.

Supporting existing Defined Benefit schemes

The IAPF is concerned that the valuable level of benefits provided by defined benefit schemes in Ireland is, perhaps, only one tax/regulatory change away from total cessation. This could leave us in the position where only State employees enjoy the benefit of a defined benefit pension promise in the future.

Our members have told us quite forcefully that the current regulatory regime, if left unaltered, will result in a dramatic reduction in defined benefit coverage in the private sector over a very short period of time. This would be a totally unacceptable and untenable outcome.

Defined benefit schemes are under significant financial pressure, due, in particular, to historically low interest rates, falls in investment markets and increasing life expectancy. In addition, schemes which introduced additional guaranteed benefits (such as converting discretionary pension increases to guaranteed) when investment markets were buoyant in the 1990s have, through the mechanics of the Funding Standard, considerably increased the technical level of reserves which they must hold.

Due to the operation of the Pensions Act, the reversal or reduction of such guarantees are fraught with difficulty and do not result in an immediate improvement in the funding position of such schemes as measured under the Funding Standard. Clearly this is an area that needs to be addressed, perhaps through giving trustees greater ability to reduce benefits in certain circumstances in the interests of achieving equity between scheme beneficiaries. Such moves could necessitate consideration of the regulation of the independence of trustees in wind ups, a position which has been adopted in the UK.

The IAPF believes that the regulatory regime for defined benefit schemes should be as supportive as possible, in light of the difficulties faced by such schemes, in order to encourage the continuation of defined benefit provision.

The current Funding Standard requires trustees of pension schemes to re-assess the funding position of their schemes on an annual basis AND requires a revised Funding Proposal to be in place if the existing level of contributions is no longer on track with that originally submitted. The IAPF believes that short term market fluctuations can result in employers and trustees entering into the process of annually re-negotiating a funding plan. This is an inefficient and costly process for scheme trustees and sponsors and can lead to dis-affection particularly amongst multi national employers with experience of defined benefit closure.

In addition, it leaves defined benefit schemes continually in the spotlight without the breathing space to achieve their long term goals.

The IAPF believes that a Funding Proposal submitted to, and approved by, the Pensions Board should remain in place for a minimum period of 3 years and that interim assessments could be completed for disclosure purposes only. The trustees would always retain the right to review the level of contributions payable if there was a significant reduction in the scheme's funding level but this review should not be forced upon them by regulation.

The IAPF believes that, in preparing a Funding Proposal, schemes should be permitted to fund their liabilities by reference to the expected long term cost of the benefits to be provided rather than the theoretical wind up position. This could be permitted provided that the sponsor can provide some other additional security or comfort to the trustees which should be disclosed to members and the Pensions Board. Further commentary on this critical area for the sustainability of defined benefit schemes is contained in our paper on the State Backed Annuity Fund.

The report on the Review of the Funding Standard stated that the view of the Board, whilst not unanimous, was in favour of a change in the wind up priorities. Subsequent legislation has not introduced any changes in this area. Our position at the time was to seek a change in the values placed on the first priority relating to pensioner liabilities with the overall ranking order remaining unchanged. Any balance of assets after providing for the ongoing liability for pensioners, transfer payments for actives and deferreds would then be used towards meeting the difference between annuity costs and the amount set aside for pensioner liabilities. This approach could potentially lead to a reduction in the benefit payments to pensioner members in the event of a wind up.

In our view the current operation of the wind up priorities does not result in an equitable distribution of a schemes assets between categories of members and we would support any initiative to improve equity between scheme members on winding up. Indeed the existing wind-up priorities are in conflict with OECD views which state "in the event that a plan is terminated and promised benefits exceed assets, there should be rules to allocate available assets to members in accordance with accrued rights and with general principles of equity."

Getting the most (pension) use from maturing SSIAs

At present, individuals who wish to increase the level of their pension contributions may do so under existing legislation, where employee contributions are based on the member's age, increasing from 15% of earnings to 30% of earnings for individuals over age 50. Therefore there will exist a mechanism for employees to utilise their SSIA funds to make up pension contributions in the year of maturity.

However, IAPF would expect that, without some form of incentive, these monies might well be directed towards other, more short term expenditure. This will not assist the Government's long term objective of reducing the dependency of the Irish working population on the State for pension purposes with the potential side effect of an unwanted inflationary spike in the months around the maturity of SSIAs.

IAPF recognise that there are a number of alternative approaches which could be adopted, including:

- permitting (all or part of) SSIA maturity values to be transferred into pension schemes or PRSAs and allowing the value to be treated for income tax purposes as a special pension contribution (or AVC) in the year of payment (without reducing the individuals capacity to make ordinary pension contributions in that year and without crystallising the exit tax originally envisaged);

- permitting (all or part of) SSIA maturity values to be transferred into pension schemes or PRSAs without crystallising the exit tax originally envisaged and treated as a special AVC;

The above options could be seen to target those on middle incomes by providing tax relief at the individual's marginal rate of income tax subject to a minimum rate of, say, 30%. In addition, the tax relief could be introduced for a specified short period of time to maximise the level of take up. This was one of the factors which resulted in the strong take up of SSIAs. Alternatively, the tax treatment could be deferred or perhaps linked to the continuation of contributions to a pension scheme or PRSA.

As the ultimate proceeds of pension schemes are, by and large, taxable, the granting of additional relief to the transfer of SSIA proceeds reflects somewhat a deferral of collection of income tax.

The sustainability of the cost of the State Pension

The IAPF considers that the financing of a proposed increase in the basic State Pension to 34% of National Industrial Earnings should be within the capacity of the Irish economy. The projected costs are expected to remain significantly less than those in other developed countries. The income redistribution inherent in PRSI (or tax) based financing of the benefit is consistent with social policy.

The IAPF would not support a significant increase in the basic State Pension at the expense of a reduction in the tax incentives granted under the voluntary Second Pillar. This would likely reduce the sustainability of the First Pillar and decrease the level of Second Pillar provision being made. This would therefore potentially lead to a future situation where the current workforce, once retired, will have lower levels of income in retirement than would otherwise be the case (as they may be likely to have saved less through the Second Pillar at a time when the affordability of a continued high level of First Pillar pension might be called into question).

Recent papers issued commenting on the current level of expenditure on First Pillar pensions and the level of tax reliefs granted to Second Pillar provision have been misleading in that they do not compare like with like and do not reflect a mature National pension system. With changing demographics, independent academic research provided to the Pensions Board argues that the gap between State pensions paid, tax collected from those over age 65 and the reliefs granted will narrow. The growth in Second Pillar assets under management is a clear indicator of this trend (please refer to Shane Whelan's report).

The tax relief granted to Second Pillar provision is, in part, deferred taxation as the ultimate pension benefits resulting from the contributions and investments are taxable.

Adjustments to the First Pillar

The IAPF recognises that not all individuals within the State may have the capacity, appetite or interest to save for their own retirement either voluntarily or mandatorily. The IAPF's preferred position is to incentivise voluntary Second Pillar provision to supplement the existing mandatory State pension.

If the additional tax incentives do not result in the desired increase in pension coverage, consideration could be given to introducing a second State Pension on a prospective basis. The design of a second State Pension could be considered further and could be:

– An additional top up State pension on a defined benefit basis; or

– An additional DC State benefit with exit terms set by the State in the year of retirement.