Society of Actuaries in Ireland

Submission to the Department of Social and Family Affairs on the Green Paper on Pensions

May 2008

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Chapter

Appendix

1. INTRODUCTION & KEY THEMES

The Society of Actuaries in Ireland is the professional body representing the actuarial profession in Ireland. The Society is dedicated to serving the public through the provision by the profession of actuarial services and advice of the highest quality. In this regard, a large number of the Society's members provide advice to trustees and employers in relation to occupational pension schemes. Many of our members also work with financial institutions in the design and supply of pension products. We believe, therefore, that we are well placed and significantly engaged to make this submission to the national pensions debate and we are grateful for the opportunity to do so.

Our submission is written in the context of the substantial changes over recent years in the environment in which pensions are delivered, as outlined in Chapter 10 of the Green Paper. In particular:

- Our research confirms that significant improvements in life expectancy across all ages have happened and are forecast to continue. This means that pensions have become more expensive, regardless of how they are provided, and this trend is expected to continue.

- The demographics of the Irish population are such that the ratio of retired persons to social welfare contributors is likely to treble over the next 40 years.

- Despite recent movements, interest rates are low by comparison to a decade ago, which impacts adversely on the cost of securing pensions. Furthermore, a protracted period of relatively low stockmarket returns coupled with more volatile investment markets have created a far more challenging set of financial conditions. This experience has highlighted the extent of investment risk to those who bear it, i.e. plan sponsors (under defined benefit plans) and plan members (under defined contribution plans).

- A consequence of these financial conditions is that risk aversion is on the increase and the inclination by companies and individuals to seek instruments which limit risk is forcing up the cost of maintaining defined benefit pension schemes.

- The move to defined contribution schemes effectively transfers all of the investment and mortality risks to employees as future pensioners. However, it is not clear that these risks are fully understood or appreciated.

- In respect of financial entities and instruments in general, there has been continued development and improvement in the rigour of financial measurement, reporting and regulation. This has been coupled with the emergence of a far greater range of financial instruments aimed at controlling financial risk. These developments have influenced the manner in which local and international authorities and regulators require the financial community to measure and manage financial risk and demonstrate solvency. It is the Society's view that similar modern principles should be employed in evolving Irish pensions regulation.

- The wind-up burden under defined benefit plans has increased due to improvements to the statutory minimum benefit "promise" to Irish employees who leave service prior to retirement. This “promise” now ranks amongst the best in the EU in terms of quantum - but not in terms of security, due to the relatively low level of solvency cover required under legislation and the relatively weak regulatory powers for achieving the appropriate funding to support the benefit promise. This disconnect, when considered in conjunction with the priority accorded to pensioners ahead of the other member classes in the event of a scheme wind-up, has the potential to create a crisis of confidence and disillusionment with the existing pensions system and its ability to deliver benefits in all circumstances.

Key themes

The Society, through its Pensions Committee and various other Committees and Council, has considered at length the full extent of the Green Paper and its content. In formulating this response, we have chosen to focus on the key themes of ***adequacy, sustainability*** and ***security:***

- ***Adequacy (Chapter 2)*** – The current voluntary system, underpinned by the State pension, is not yet delivering on the overall adequacy target set by the National Pensions Policy Initiative of 50% replacement income in retirement. It seems probable that the current system will need to be enhanced, if the declared overall adequacy target is to be achieved.

  The Society’s view is that if, from a public policy perspective, any further layer or mechanism of mandatory provision is considered necessary in order to achieve a specific adequacy target, the most effective approach is to raise the State pension, rather than introduce mandatory or “soft mandatory” saving under defined contribution arrangements.

  We comment in the submission on the effectiveness of the State pension mechanism. We propose that the State pension should be increased in conjunction with an increase in the State pension age and we outline the cost implications of these proposals.

- ***Sustainability (Chapter 3)*** – With a view to the sustainability of the State pension system, we recommend that the State pension age should be increased. We believe that this is necessary having regard to the extent to which life expectancy has increased and the level of expected future increases. Moreover, if the State leads the way by increasing the State pension age, this will open up the possibility of occupational pension schemes doing likewise, which might ultimately make defined benefit schemes widely affordable again or, at a minimum, might support wider implementation of hybrid schemes. The submission includes an outline of cost implications and practical considerations in relation to increasing the State pension age.

- ***Security (Chapter 4)*** – The Society believes that, as far as defined benefit pension schemes are concerned, the current pensions system over-promises and under-funds and scheme members (especially current employees) are exposed to far greater risks than are commonly understood. At a minimum, the regulatory approach should be changed to provide increased transparency. We advocate a regulatory model similar to those operated in other EU countries under which a more rigorous minimum funding regime would apply, possibly to a reduced "core" benefit promise. We also argue for a more equitable system of achieving benefit security, in the event of scheme wind-up, between retirees (whose benefits are given top priority under the current system) and current employees (who receive a far lower level of protection).

In Chapter 5, on ***other considerations:***

- We recommend a number of reforms in relation to social insurance contributions;

- In relation to defined contribution pension plans, we emphasise that education and communication initiatives should be a key priority on an ongoing basis, we advocate simplification of the regulatory regime, and we call for extension of the Approved Retirement Fund option to all members;

- We outline why we believe that the current tax relief model is an effective one, though it needs to be communicated better;

- We comment on other means of incentivising long-term saving, such as auto-enrolment, pre-retirement access to funds, greater flexibility of retirement age and wider choice in annuity products.

In Chapter 6, we comment on ***public sector pensions****.* We emphasise the need to determine the cost of benefits on a normal commercial basis and we recommend that the State should be subject to the same rigour in respect of the financial and risk management aspects of pension provision as is applied to private sector companies.

2. ADEQUACY

The Green Paper highlights the two principal issues arising in relation to the adequacy of current pension provision:

- Approximately 45% of workers are not members of pension schemes, and
- For many of the 55% of workers who are scheme members, social welfare pensions are likely to be an important source of secure retirement income, for various reasons, including low contribution levels to defined contribution arrangements, broken service in defined benefit arrangements, and the fact that many low-income workers are in occupational pension arrangements that are integrated with the State pension.

The Green Paper sets out a number of options for closing the gap in retirement savings, and these are summarised in the recently-published OECD Economic Survey 2008 as follows:

- The current voluntary system but with enhanced incentives to save through matching contributions;
- Mandatory pension saving for workers without adequate alternative arrangements;
- A "soft mandatory" system - workers would be able to opt out of this scheme under certain conditions;
- Enhancing the social welfare pension so that there is less need for private saving.

The current voluntary system, underpinned by the State pension, is not yet delivering on the overall adequacy target set by the National Pensions Policy Initiative of 50% replacement income in retirement. Continued efforts to improve pensions awareness and, potentially, enhanced incentives to save may bring about progress in this direction. However, it seems probable that the current system will need to be enhanced, if the declared overall adequacy target is to be achieved.

The Society's view is that if, from a public policy perspective, any further layer or mechanism of mandatory provision is considered necessary in order to achieve a specific adequacy target, the most effective approach is to raise the State pension, rather than introduce mandatory or "soft mandatory" saving under defined contribution arrangements. Any increase in State pension should be considered in conjunction with an increase in the State pension age. We return to the age issue under "Sustainability".

We comment overleaf on the effectiveness of the State pension mechanism. We believe that this is the most effective mechanism for delivery of the desired adequacy target. There will always be a role for further voluntary provision by those who can afford it – but if the overall adequacy target is substantially delivered through the mechanism of the State pension, the need for further mandatory or "soft mandatory" arrangements will be reduced. Specifically, if the State pension were to be enhanced, the existing policy target of 70% for supplementary pensions coverage would require review, as this derived from an underlying adequacy target for retirement income of 50% of pre-retirement income combined with a target rate for the State pension of 34% of average earnings.

We recognise that increasing the State pension would have cost implications and we comment further on this on page 2.4. Cost implications could - and, we believe, should - be mitigated by increasing the State pension age. We return to the issue of State pension age under "Sustainability".

<u>Effectiveness of State pension mechanism</u>

Our reasons for believing that any further mandatory provision should be achieved by raising the State pension are as follows:

- **An increase in the State pension would be by far the simplest approach to administer and by far the most cost-effective way to enhance pension provision.** It is an established and robust mechanism – as the system is already in operation, there will be no incremental delivery costs for incremental benefits. Moreover, even if charges are regulated in a mandatory or "soft mandatory" savings system, the costs of administering individual contribution and investment records in parallel with the cost of administering the current social insurance system would necessarily add significantly to overall administration costs.

- **The State pension is a "defined benefit" as compared with the "defined contribution" nature of a private mandatory or "soft mandatory" savings scheme.** This has the advantage that individuals are not exposed to investment risk. Under a defined contribution arrangement, the members bear all of the investment risk and adverse investment conditions in the period preceding retirement can have very damaging consequences, particularly for lower-paid workers. A defined benefit arrangement also protects the pension recipient from the risk of pension erosion due to changes in life expectancy.

- Unlike a mandatory or "soft mandatory" defined contribution arrangement, **the State pension pools mortality risk, i.e. it provides the same level of benefit, regardless of whether individuals live shorter or longer than average, and this cross-subsidisation results in more efficient benefit delivery to pensioners.** Under the State pension mechanism, the extra cost of providing lifetime income to those who live longest is financed from the "savings" that arise when other pensioners do not reach average life expectancy. There can be no such "pooling" in a private sector defined contribution model with optional annuity purchase since mortality "savings" in respect of an individual who does not reach average life expectancy are transferred to the individual's estate. Similarly, the same level of savings under a defined contribution arrangement will produce lower benefits for women than for men, whereas the State (defined benefit) pension mechanism would deliver gender-neutral benefits. This is because the State pension mechanism allows for an averaging out of differing pension costs for men and women, whereas under a private sector defined contribution plan, women's pensions are more expensive than men's due to longer life expectancy.

- **An increase in the State pension would address the adequacy gap for workers who are currently close to retirement, as well as younger workers,** whereas a mandatory or soft mandatory savings scheme would deliver little benefit for those who would not be making contributions over a full career.

<u>Issues to be addressed</u>

In choosing this option as our preferred option for enhancing pension provision, we note that the following issues need to be addressed:

- This option would not provide certainty, as ultimately the level of State pension is a political decision, on a year-by-year basis. In this context, we support the recommendation in the recent OECD Economic Survey report that "a commitment to an objective in terms of average earnings would make clear the projected value of future pensions and help clarify the associated fiscal liability". The Survey report also notes that this is a common practice in other OECD countries.

- If this option is pursued, it would become even more pressing to address the issue of the State pension age. We believe that these two issues should be addressed in tandem, and we discuss this further in Chapter 3, "Sustainability".

- The State pension is redistributive, i.e. contributions from high-earners subsidise benefit provision for low-earners and low-earners enjoy higher replacement rates (ratio of State pension to pre-retirement earnings) than high-earners. The OECD Economic Survey notes that the existing commitment to raising the State pension for a single person to €300 per week by 2012 implies a significant increase in real terms – from approximately 34% of average earnings to approximately 40%. Compared with other OECD countries, this will result in a relatively high replacement rate for those with below-average earnings – for example, a person with pre-retirement earnings of 50% of average earnings may[1] receive a State pension of over 80% of those earnings, compared with a norm of 60% - 80% in most other OECD countries. Likewise, any further increase in State pension above the current commitment of €300 would further increase the replacement rate for those on low incomes. It is a matter for public policy to determine the appropriate extent of redistribution within the State pension system. Again, the issue is linked to the issue of retirement ages, which we discuss further in Chapter 3, "Sustainability".

- If a step increase in State pension is effected, then, under defined benefit schemes under which the benefits are integrated with the State benefits, members' scheme benefits will be reduced and there will be contributions savings for employers. In this context, it is reasonable to expect that part of the cost of an enhanced State pension would be borne by employers.

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[1] The outcome depends on the level of inflation in the meantime.

Costs

We recognise that any increase in the State pension would result in an increase in the social insurance contribution rates required to finance this pension, in an environment in which increases in contribution rates are also likely to be required to reflect demographic change. We emphasise that revised contribution rates should properly reflect the cost of financing the benefits provided by the social insurance system. A subvention from general taxation revenue could also be considered.

In Chapter 3, “Sustainability”, we comment on the desirability of increasing the State pension age. This would help to offset the cost of any enhancement to the current level of State pension and we believe that a fair trade-off could and should be achieved. We therefore return to the question of costs in Chapter 3.

Of course, increased pension provision will lead to increased costs, regardless of the mechanism or vehicle used. The costs will be covered in different ways under the different mechanisms – e.g. increased social insurance contributions and/or taxation if the State pension is increased, or increased contributions to defined contribution plans if the alternative private mandatory or “soft mandatory” options are chosen. Therefore, the extent of any required increase in social insurance contribution rates would need to be considered relative to the costs of the alternative policy options, rather than in isolation.

Ultimately, the amount of any increase in State pension will be a government policy decision and relevant considerations will include costs, societal priorities and the effectiveness of the State pension mechanism compared with other means of improving the adequacy of pension provision.

3. SUSTAINABILITY

Sustainability of pensions provision essentially involves three variables:

- The level of benefits
- The level of contributions, and
- Retirement age.

With a view to the sustainability of the State pension system, the Society recommends that the State pension age should be increased.

We believe that this is necessary having regard to the extent to which life expectancy has increased and the level of expected future increases. As noted in Chapter 2 of the Green Paper, life expectancy at birth increased by 2.1 and 1.7 years respectively for men and women between 1996 and 2002, which represents a rapid closing of the gap in life expectancy with other EU countries. Based on the latest mortality assumptions published by the Central Statistics Office, we estimate that, by 2040, cohort life expectancy[2] for 65 year old men and women will increase from the current levels of approximately 21 and 23 years respectively to approximately 25 and 27 years (see Appendix 1). We also note that:

- The extra years of life expectancy gained to date appear to be largely healthy years, i.e. the onset of significant disability is postponed;
- Several other European countries have already announced increases in retirement age to take account of increases in life expectancy.

If the State leads the way by increasing the State pension age, this will open up the possibility of occupational pension schemes doing likewise, which might ultimately make defined benefit schemes widely affordable again or, at a minimum, might support wider implementation of hybrid schemes.

We recognise that very significant increases in current social insurance contributions are required to sustain the current level of State pension (see “Cost trade-off…” on page 3.2) and that increasing the State pension age would alleviate the increases only to a relatively modest extent, as discussed in Chapter 3 of the Green Paper. However, our view is that the current State pension is the best means by which to achieve socially desirable levels of adequacy of retirement income for the overall population in an effective and cost-efficient manner – and the increased benefits proposed in Chapter 2, “Adequacy”, should become payable from a higher State pension age, as it is reasonable and appropriate to trade off longevity improvements against benefit levels.

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[2] *“Cohort life expectancies are calculated using age-specific mortality rates which allow for known or projected changes in mortality in later years and are thus regarded as a more appropriate measure of how long a person of a given age would be expected to live, on average, than period life expectancy.”* [UK Government Actuary’s Department]

Cost trade-off between amount of State pension and State pension age

An increase in the State pension age would help to offset the emerging cost of financing any enhancement to the current level of pension provision. Given current concerns about both adequacy and sustainability, this would appear to be an appropriate trade-off.

The appropriate amount of any increase in State pension, and any change to State pension age, will be a matter for government to decide, taking a number of factors into account.

Irish social insurance contribution rates are currently among the lowest in the EU, as illustrated in the table below.

Social insurance contribution rates

	Old-age and early retirement	Old-age, early retirement, disability	Coverage broader than previous col.	Tax financing
Belgium			**38%**	**1/3rd of total social security financing**
Germany		**20%**		**28% of total expenditure**
Spain		**22%**		
Italy		**33%**		
Netherlands		**26 – 33%**		
Portugal			**35%**	**3.8% of GDP**
Finland		**24 – 28%**		**1.7% of GDP**
Sweden	**20%**			**Disability and survivors' pensions**
UK			**20%**	**Disability and survivors' pensions**
Ireland			**12.5 – 14.75%**	

We recognise that the cost of the current State pension is set to rise significantly over the coming decades. The recent Actuarial Review of the Social Insurance Fund estimated the "equalised contribution rates"[3] that would be required immediately and throughout the projection period 2008 – 2061 to fund the current State pension. The Review concluded that "equalised contribution rates" of 174% of current contribution rates, i.e. 22% - 26%, would be required.

These long-term contribution rates are comparable to the current State spend in other EU countries. We acknowledge that at least some other EU countries are concerned about projected future increases in pension costs – but we emphasise that the comparison here is between <u>projected long-term costs</u> in Ireland and <u>current</u> spend in other countries.

In relation to a decision on the amount of any change in State pension and State pension age, it is worth noting that:

- The estimated "equalised contribution rates" required over the period to 2008 - 2061 to fund the current State pension are 174% of current contribution rates, i.e. 22% - 26%, as stated above;

- If the State pension was increased to 50% of Gross Average Industrial Earnings (immediately) in combination with an increase in the State pension age to 70 by 2050, the "equalised contribution rates" for this combination over the projection period would be 201% of current contribution rates (i.e. 25% - 30%)[4]. That is, the net additional long-term cost, compared with the cost of the current State pension, is estimated as an additional contribution of approximately 3 – 4% of earnings.

These figures are extracted from the 2007 Actuarial Review of the Social Insurance Fund. They may need to be revisited in light of further improvements in mortality since the Review was carried out.

<u>Practical considerations</u>

Significant advance notice needs to be given of any increase in State pension age. We suggest that minimum notice of the order of 15 years is probably required as to the State pension age that will apply at a particular date. It is therefore imperative that this issue is addressed as a priority.

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[3] Equalised contribution rate means the contribution rate that would be required to balance income and expenditure in the Social Insurance Fund over the relevant projection period (without allowing for the current surplus in the Social Insurance Fund and assuming no contribution from the Exchequer).

[4] Table 7.2(g) of the 2007 Actuarial Review of the Social Insurance Fund

The recent OECD Economic Survey report recommended indexing the State pension age to longevity over the longer term. There are various ways in which this might be achieved. In practice, however, an increase in the State pension age of at least one year per decade would be needed to keep pace with current estimates of expected future improvements in life expectancy (without taking into account the gains that have already been achieved in recent decades).

In the debate about State pension age, concerns are often expressed about the ability of people in some occupations to continue to work beyond the current State pension age. We suggest that the level of State pension should be increased (as discussed in Chapter 2, "Adequacy") and that an early payment option should be available from age 65, with benefits reduced to reflect the earlier payment date. This option would help to ease the transition to a higher normal pension age and would offer choice where needed. Similar payment options are available in other EU countries. Late payment options should also be introduced to facilitate those who wish to work beyond the State pension age. Reform of the State Transition Pension (currently payable between ages 65 and 66) will be essential in order to enable phased retirement.

Consideration should be given to the legislative changes that would be required in order to facilitate increases in retirement age under occupational pension schemes, e.g. changes to legislative provisions relating to preservation of accrued benefit. If there was scope for scheme members / sponsors to defer retirement / raise the normal retirement age, this could be of substantial help in addressing current solvency / funding difficulties.

Societal change

The labour market will need to adjust to increased life expectancy and it will require more than an increase in the State pension age to bring this about. Raising employment rates amongst older workers in particular is an important component to ensuring the future sustainability of the social insurance system. This is likely to require dedicated initiatives, such as education and retraining schemes, and both government and employer incentives.

4. SECURITY

The Society is concerned that, under the current private occupational defined benefit pensions system:

- o Benefit provision exists on a voluntary basis, within a “light” regulatory environment that encourages and supports defined benefit provision but does not impose adequate security for scheme members’ benefits.
- o There are varying degrees of understanding among stakeholders (employers, trustees and members) of the fact that benefit provision is dependent on adequacy of resources.
- o In contrast to the light regulatory approach to security of benefits, statutory minimum benefit “promises”, such as index-linked preservation, are among the most generous in the EU.

In the Society’s opinion, as far as defined benefit pension schemes are concerned, the current system over-promises and under-funds and scheme members (especially current employees) are exposed to far greater risks than are commonly understood.

<u>Risk exposures in defined benefit schemes</u>

The risk exposures in defined benefit schemes include those deriving from the following factors:

- o In the event of wind-up, liabilities in respect of current pensions are a first charge on the assets.
- o Schemes tend to hold the majority (c. 70%) of their assets in equities.
- o The combination of the above factors means that, for the typical employee, his/her pension may be of similar risk to a geared equity investment, in that a fall in equity values may have a disproportionately large adverse impact on the security of employees’ benefits. This is illustrated in Appendix 2. The practical effects of employer support and managing recovery from low funding levels over a relatively long period may reduce this in some instances – but not all.
- o The risks grow as defined benefit schemes become more mature and pensioners represent a greater proportion of the liabilities.

Even if members understand the risks, they are generally powerless to change matters since scheme membership is usually a condition of employment and legislation underpins current inadequacies.

Inadequate funding, high scope for disappointment

The wind-up/leaving service rules of a pension scheme typically confer an employee with a benefit represented by a pension payable from age 65 - and subject to CPI-linked pension indexation during the deferred period.

It is necessary to capitalise this pension in order to determine the amount of assets required to satisfy the Minimum Funding Standard (i.e. the amount of the transfer value). For current and former employees (active and deferred members), the current regulations are set around a standard set of assumptions that allows for an "excess" equity return in the period leading up to retirement age (with the extent dependent on the term to retirement).

This means that, for active and deferred members, the current minimum statutory transfer value approach places a lower capital valuation on a member's deferred benefit expectation than the economic value[5] of the liability. Also, the allowance for CPI-linked indexation represents a medium-to-long-term view which, again, is lower than the current economic value.

For instance, for a member aged 40, it is estimated that the statutory minimum transfer value as currently calculated would be less than 50% of an economic valuation. This means that, even where a scheme satisfies the statutory minimum funding standard on wind-up, employees may currently receive a capital sum which is unlikely to be sufficient to provide benefits in line with their previous expectation unless it is invested in relatively risky assets, such as equities and property. Allowing for an “excess” equity return in the calculation of the transfer value effectively transfers the future investment risk in respect of the deferred pension expectation to the employee. This might not be unreasonable in the case of an optional transfer from one employer/scheme to another, but it seems inappropriate in the case of a wind-up.

Combining this with the fact that pensioner liabilities are a first charge on the assets in the event of a wind-up, the scope for disappointment amongst current employees and deferred pensioners in a wind-up situation is immense.

Other weaknesses in the regulatory regime

It is understandable that plan sponsors usually wish to pursue high-equity investment strategies with the objective of minimising long-term funding costs and potentially generating "excess" resources to provide for discretionary benefits such as pension increases. However, the analysis illustrated in Appendix 2 serves to demonstrate the scope for downside risk - particularly for employees in schemes that have a large pensioner population. With the closure of many defined benefit schemes to new entrants, this issue is likely to become more relevant.

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[5] “Economic value” means the present value of the benefit obligation based on prevailing yields on government fixed interest stock of suitable term and realistic estimates of mortality, including allowance for future mortality improvements.

Current legislative policy places investment responsibility entirely in the hands of scheme trustees and the Pensions Board has no regulatory authority to intervene where the investment policy is high risk (e.g. heavy equity position being unsuitable due to maturity of plan, poor creditworthiness of sponsor or sheer size of plan relative to sponsor). Solvency, on the current weak basis, is reported annually but, where insolvency occurs, there is usually scope for trustees and sponsors to agree to make good the shortfall over a period of up to 10 years - often relying on equity out-performance to repair the deficit.

Thus, the current regulatory system places a lot of faith in the ability of equity markets to deliver on benefit expectations. Arguably, the current regime encourages companies and trustees to take extra risk in order to restore a scheme to solvency without any material consideration of the risks. In particular, the contribution requirement is generally reduced by making higher allocations to equity and property and taking advance credit for the expectation of higher return on these asset classes, without reference to risk and employer covenant.

The Irish model differs fundamentally from the regulatory approach operating in other jurisdictions. For instance, in the United Kingdom, the Pensions Regulator and trustees are empowered to insist on a far higher level of funding from plan sponsors, and a shorter timeframe to repair deficits, than is the case here in Ireland. Here, the regulatory regime limits the capacity of trustees to address the issues and, as noted above, creates incentives to rely on (hoped-for) outperformance of equities to repair funding deficits in situations where a high-equity strategy might not be appropriate from a risk perspective. In addition, the Pensions Regulator takes account of employer covenant when signing off on a specific funding proposal. When these facts are considered alongside the UK debt-on-employer requirements and Pension Protection Fund, we can see that the UK approach offers a higher level of protection, albeit at a commensurately higher level of cost.

Recommendations

In summary, the Society's view is that the current model for private occupational defined benefit pension schemes is deficient in that it:

- over-promises and under-funds
- exposes benefits to far greater risks than are commonly understood
- places the lion's share of the risk on current employees, and
- limits the capacity of trustees to address the issues.

Our recommendations in this regard are as follows:

1. To improve benefit security, the Society recommends that Irish minimum funding legislation be strengthened by requiring that benefit <u>promises</u> be funded as follows:

- Value benefit promises on an economic basis[6].

- Establish a "hard floor" trigger point, based on this valuation of benefit promises, with a requirement to repair under-funding below this level over a short (e.g. 12 month) period.

- Set a higher "target funding level" having regard to the risk profile of the scheme's investments (e.g. in excess of 100% of the economic valuation of benefit promises where a high equity weighting applies but close to "hard floor" for a matched investment strategy), with scope to address under-funding below the "target funding level" over a longer (e.g. 15 year) period.

2. If, for particular defined benefit schemes, it is considered that the financial implications of this approach are unacceptable and could threaten the continued existence of the scheme, then the Society's view is that it would be desirable to alter the "promised" benefits along the lines outlined below in order to improve transparency and security:

   - Allow scheme sponsors to redefine benefits in terms of affordable "core" benefits and discretionary additional benefits that <u>would be targeted</u> but could be postponed in certain circumstances, e.g. periods of adverse financial conditions;

   - Subject the lower core benefits to a rigorous system of minimum funding legislation along the lines of that described in 1. above;

   - Apply a lighter minimum funding requirement (analogous to long-term funding) to the excess of the total target benefit over the core benefit.

   One approach to delivering lower "core" benefits could be to remove current obligations to provide for revaluation of preserved benefits prior to retirement (and also any obligation under a plan's rules for post-retirement pension indexation), i.e. similar to the Dutch conditional indexation approach. Under such an approach:

   - Indexation would be targeted, with the intention that it would be provided;

   - Core benefits (excluding indexation) would be subject to a stricter funding regime than currently applies (based on an economic valuation of benefit obligations, without allowance for potential future out-performance by equity investments);

   - However, a lighter minimum funding requirement would be applied to indexation on the basis that actual provision of indexation would be dependent on the funding level of the scheme from time to time – i.e. indexation would be foregone if and when a deficit was experienced but surpluses would have to be applied in the first instance to restore any indexation previously foregone.

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[6] That is, move to the 'economic value' approach described earlier for valuing liabilities in respect of active and deferred members. Pensioner liabilities would continue to be valued using the current annuity costs approach.

Such a conditional approach to post-retirement indexation would go some way to restoring equity between pensioners and employees, in terms of security of benefits. It would address the arguably unintended consequences of introducing CPI-linked preservation legislation. It would improve investment flexibility, which should be beneficial to long-term returns. It would help stem the flight from defined benefit to defined contribution schemes and encourage more affordable hybrid schemes.

Overall, a conditional indexation approach could represent a valuable “middle ground” in terms of the design and delivery of defined benefit pensions. Of course, there may be other, valid approaches to delivering lower “core” benefits, including the application of a hybrid pension design comprising core defined benefit together with defined contribution top-up. The Society would be happy to help explore other options.

We emphasise that we are not proposing that employers be allowed to reduce the benefits and/or security of benefits under existing schemes where these are affordable. Rather, we are proposing that measures be introduced to facilitate more transparent, and ultimately more secure, benefit structures for new schemes and for existing schemes that are currently over-promising and at risk of under-delivering.

3. To address equity amongst all beneficiaries, the current wind-up priority for current pensioners should be removed so that, in the event of an insolvent wind-up, all classes of member would rank equally. The analysis illustrated in Appendix 2 demonstrates the downside risk that the current priority rule creates for other classes of member, particularly in schemes that have a large pensioner population. Currently, even a relatively modest fall in investment values could lead to active and deferred members receiving much-reduced benefits in the event of the wind-up of a scheme that had previously met the funding standard. We believe that this is inequitable – and not well understood.

   If the proposals at 2. above are adopted, we suggest that “core” benefits should be given priority ranking in a wind-up, with any surplus remaining being applied to benefit increases, all categories of member ranking equally in each stage of this exercise.

4. One could also consider the possible introduction of debt-on-employer legislation and a Pension Protection Fund financed by risk-related levies on pension funds.

   In principle, the Society sees merit in these measures. However, in practice, we believe that they would be difficult to introduce, and we note that the introduction of mandatory employer debt could prompt a rush to wind up schemes before the debt provision took effect. In any event, if employers become insolvent and few, if any, assets are available to meet the debt, it is of little or no value. We believe that the core issues of improving the security of members’ benefits, achieving greater equity between categories of members in terms of benefit security and improving all stakeholders’ understanding of the benefit “promise” need to be successfully addressed before debt-on-employer provisions or a Pension Protection Fund can be meaningfully considered.

5. OTHER CONSIDERATIONS

(A) Reform of Social Insurance pensions

The Society believes that the current "average contributions" test should be replaced by a "total contributions" test. In our view, the current "average contributions" basis is opaque and inequitable.

A long lead-in to the introduction of a total contributions basis would help with the logistical issues highlighted in the Green Paper. For example, introduction after 2019 would largely eliminate issues relating to the fact that computerised records are not available for years prior to 1979.

Across the EU, aggregate years' contributions in the range 35 – 45 years are required to qualify for full benefits. In the context of increasing life expectancy, we suggest that 45 years' paid or credited contributions would be an appropriate requirement for a full State pension. This should increase in line with future increases in the State pension age. Concerns about the regressive nature of increases to the State pension age could also potentially be addressed by allowing the full State pension to be paid as soon as the contribution threshold is reached. This would benefit those who join the workforce at an earlier age and whose earnings are likely to be lower than those who remain in education for a longer period.

We note that it may be appropriate to allow individuals with contribution gaps to make voluntary additional contributions to achieve the maximum contributory State pension.

We also suggest a system of credited contributions, rather than the current system of "disregards", for homemakers, carers, jobseekers, etc.

(B) Defined Contribution Arrangements

Awareness / education

A key concern in relation to defined contribution arrangements is that there is a widespread lack of awareness among employees of:

- o The level of contribution required for a given target level of retirement income, and
- o The implications of, and risks inherent in, any given investment strategy.

The Society welcomes the forthcoming introduction of Statements of Reasonable Projection for defined contribution schemes, which will go some way towards helping members in their long-term financial planning. However, there is scope to go much further in education and communication initiatives and the Society considers that this should be a key priority on an ongoing basis.

Simplification

The range of pension structures available offers choice but also complicates the market. We believe that some simplification of the overall regulatory regime would deliver benefits. For example, point-of-sale requirements could be examined to determine whether easier access to pension plans could be facilitated. Differences in terms of options available under the different plan types could be removed or reduced. Transferability between the different plan types could be improved. Such steps would make pensions provision easier for employees, employers and product providers and could encourage a broader range of providers into the market.

Approved Retirement Funds

We believe that the ARF option should be extended to all members of all defined contribution arrangements. It is inequitable to require some members of such plans to purchase an annuity at retirement, regardless of annuity costs at the time, while exempting others from the requirement. However, current tax anomalies should be addressed. As any money in an ARF has received income tax relief, we believe that such money should also be subject to income tax when withdrawn from the ARF. ARFs should not be passed to estates as low-taxed inheritances.

The need for, or appropriateness of, ARFs under defined benefit schemes is less clear-cut, given that the primary *raison d'etre* of such schemes is to provide a specified level of retirement income. There may be an argument for extending ARFs to defined benefit schemes in the interests of a level playing field between defined benefit and defined contribution plans in terms of benefit options. However, if ARFs were to be extended to defined benefit schemes, a number of issues would need to be carefully considered first, such as the implications for funding strategies and investment strategies and the basis on which pensions would be converted to lump sums.

At present, there is a requirement for an individual effecting an ARF to have a guaranteed income of at least €12,700 or to place €63,500 in an Approved Minimum Retirement Fund (AMRF). The Society recommends that the latter test should be abolished - the primary requirement is to ensure that the individual concerned has a minimum guaranteed income, and, in any event, an AMRF of €63,500 is of much lower value than a guaranteed income of €12,700 per annum. We also consider that the minimum income test should be indexed to ensure that it maintains its value relative to increases in earnings.

(C) Other measures to improve incentivisation of (defined contribution or defined benefit) private pension provision

Tax relief

We believe that the current system of tax relief is an effective approach to incentivising long-term saving, but it needs to be communicated better to help people to understand the value of the relief.

The current system is sometimes criticised for giving too much relief to high earners – but this ignores the tax that will be payable on pensions in payment. In fact, the current system gives most relief (on an effective basis, i.e. net of discounted tax on pensions) to people not far above the marginal tax band and saving a moderate amount for retirement. **Please refer to Appendix 3**, which illustrates this point and also sets out further views from the Society on tax relief and on the alternative or supplementary approach of capped matching contributions.

Auto-enrolment

As outlined in Chapter 2 on "Adequacy", we believe that the State pension mechanism is the most effective system for delivering whatever level of minimum retirement income is considered socially desirable from a public policy perspective. However, we noted that there will always be a role for further voluntary provision by those who can afford it. Such voluntary provision could be further stimulated by introducing some form or degree of auto-enrolment for persons above a specified minimum income level. For example, this could involve auto-enrolment in a PRSA where there is no existing pension scheme in place – or a requirement for employers to engage with employees as part of annual pay negotiations to discuss the possible introduction of auto-enrolment. An option to opt-out or withdraw from the plan would be available.

Auto-enrolment could be successful in bringing more people into the habit of long-term saving. There would, however, be substantial work and costs involved in establishing and, on an ongoing basis, operating and enforcing such a system. It would be essential to ensure that any form of auto-enrolment introduced did not detract from the effectiveness and quality that currently exists in many instances of occupational pension provision.

Pre-retirement access to funds

We believe that allowing the option of pre-retirement access to funds on a restricted basis would provide a major boost to long-term saving. The success of Special Savings Incentive Accounts supports this premise. A corresponding offset against tax-free cash at retirement could be applied.

Flexible retirement age

We propose that flexibility with regard to retirement age should be allowed. Scheme members should be allowed the facility to draw a pension while continuing to work part-time. This would help enable a transition to a higher State pension age and higher normal retirement age under occupational pension schemes.

Options on form of annuity

Unit-linked annuities and other types of annuity product innovations should be allowed, at least for benefits over a core level (e.g. pension increases). This would provide flexibility and stimulate product design options.

6. PUBLIC SECTOR PENSIONS

Quantum of benefits

The level of public sector pension provision is a matter for Government. The Society's primary concern is that the cost of the benefits provided should be determined on a normal commercial basis as one component of an overall benefit package and in the context of overall budgetary constraints / affordability.

Public sector pension schemes include a number of design features that are highly valuable to employees and costly to the exchequer but which would be unusual in the private sector. Additionally, public sector employees have greater job security and therefore a greater proportion retire with a pension based on 40 years of service than is the case in the private sector. It is important that the various provisions of public sector schemes are properly costed in terms of the assessment of the overall value of the remuneration package. The appropriateness of some of the design features may merit review. In particular, linking pension increases to salary increases is a very unusual and expensive feature that seems difficult to rationalise or justify.

Financial and risk management of public sector pensions

We consider that the State should be subject to the same rigour in respect of the financial and risk management aspects of pension provision as is applied to private sector companies. The cost of public sector pensions should be determined on a realistic basis and the principles of underlying modern accounting standards, such as IAS 19, should be applied in the valuation of public sector pension obligations and annual charge. Unfunded accrued pension benefits should be valued on a realistic basis and accounted for as part of the national debt.

Pre-funding of benefits

From a security perspective, the need to pre-fund public sector pensions is much reduced, relative to the private sector, where the benefits are only as secure as the underlying funding level, risk and liability profile and sponsor's covenant.

From an investment policy perspective, a decision on whether or not to pre-fund public sector schemes should give consideration to the merits, risks, costs and rewards of conventional pension fund investment relative to those of investing in the economy and infrastructure. Detailed discussion of the pros and cons of each is beyond the scope of this document.

Pre-funding would bring added financial discipline to public sector pension management generally. It would also level the playing field, relative to private sector schemes. However, if low or nil advance funding is preferred, then the application of disciplined accounting practices would go a long way towards facilitating greater financial rigour and transparency, as noted above.

APPENDIX 1

Life expectancy

Life expectancy has increased by approximately three years per decade in the past two decades and current projections allow for further significant increases in coming decades.

To illustrate this, the table below shows projected "cohort life expectancies"[7] from age 65 for men and women. We have calculated these life expectancies using the assumptions regarding future mortality improvements outlined in the Population and Labour Force Projections 2011 – 2041 published by the Central Statistics Office in April 2008.

To date, projections of future mortality experience have substantially under-predicted the actual level of mortality improvements that have been experienced. We note that there are potentially significant future life expectancy gains that are not built into current projections in the event of future advances in medical science – though we acknowledge that there is no certainty that such advances will be achieved.

Projected cohort life expectancy from age 65

	Men	**Women**
2006	**21**	**23**
2020	**23**	**25**
2030	**24**	**26**
2040	**25**	**27**
2050	**26**	**27**

[7] *"Cohort life expectancies are calculated using age-specific mortality rates which allow for known or projected changes in mortality in later years and are thus regarded as a more appropriate measure of how long a person of a given age would be expected to live, on average, than period life expectancy."* [UK Government Actuary's Department]

APPENDIX 2

Illustration of impact of priority rule on wind-up combined with high-equity investment strategy

The following simplistic example illustrates the priority/risk point. It is based on an example of a fund with Minimum Funding Standard liabilities of €100m that are exactly matched by its assets at 1st January of €100m (invested 70% in equities).

Based on historic norms, such an investment strategy has a 5% chance (i.e. expected to occur 1 year out of 20) of producing a 1-year investment return worse than -30%. For the purposes of this example, it is assumed that a -30% return is recorded. The table below illustrates the deterioration in the funding position from 1st January to 31st December. The outcome for employees is very sensitive to the maturity of the scheme (i.e. the proportion of liabilities related to pensioners) so the analysis shows pensioner liability weightings ranging 0% to 75%.

Position at 1st January				
Fund	€100m	€100m	€100m	€100m
MFS liabilities in respect of -pensioners -employees -total	 €0m €100m €100m	 €25m €75m €100m	 €50m €50m €100m	 €75m €25m €100m
% asset coverage pensioners	**n/a**	**100%**	**100%**	**100%**
% asset coverage employees	**100%**	**100%**	**100%**	**100%**
Position at 31st December				
Fund	€70m	€70m	€70m	€70m
MFS liabilities in respect of -pensioners -employees -total	 €0m €100m €100m	 €25m €75m €100m	 €50m €50m €100m	 €75m €25m €100m
% asset coverage pensioners	**n/a**	**100%**	**100%**	**93%**
% asset coverage employees	**70%**	**60%**	**40%**	**0%**

APPENDIX 3

Submission to the Commission on Taxation

The Commission on Taxation is currently carrying out a review of taxation and has invited submissions. The Society of Actuaries in Ireland has submitted comments towards that part of the review relating to "*how best the tax system can encourage long term savings to meet the needs of retirement*". These comments are as follows:

Tax relief on pension savings

1. Currently, there are significant tax incentives to pension saving in Ireland. Pension contributions are deductible at the marginal rate of income tax and PRSI contributions are calculated on earnings excluding pension contributions. Investment returns on pension investments are not taxed. Pensions are subject to income tax, but most retirees can convert part of their pension into a tax-free lump sum at the point of retirement.

2. It is important to note that, notwithstanding these generous tax incentives, many people are not saving for retirement and many more are not saving amounts that are adequate to provide an income in retirement in line with current Government policy objectives (i.e. that pensioners have an income of at least 50% of their pre-retirement income).

3. The Society's view is that the current system of tax relief is an effective approach to incentivising long-term saving. We believe that the system should be maintained, but that it needs to be communicated better. The provision of tax incentives, and effective communication of those incentives, is essential to encourage people to save for retirement.

4. The current system has been criticised for giving too much relief to high earners, but this ignores the income tax that will be payable on pensions in payment. In fact, our analysis shows that the current system gives the highest effective rate of relief (on a lifetime basis i.e. net of the discounted tax payable on pension income) to people whose earnings are not too far above the threshold for the higher rate of income tax and who are saving a moderate amount for retirement. We believe that this is a reasonable outcome (while acknowledging, of course, that high earners receive substantial benefits in absolute terms). Further detail in relation to our analysis is provided in paragraphs 5 to 11 below.

Value of tax relief on pension savings

5. The recent OECD Economic Survey of Ireland 2008 report has argued that our tax system, which aims for pension savings, returns and income to be subject to an "exempt-exempt-taxed" (EET) regime, is in fact fairly close to being an *"exempt-exempt-exempt" (EEE) system where income channelled through pensions is unlikely to be taxed at any point of the life-cycle."* The OECD report, and many others, have also argued that tax incentives to pension saving are poorly targeted and are of greatest benefit to higher earners who pay the higher rate of income tax of 41%.

6. However, the view that the current system of tax relief for pension savings is of maximum benefit to higher earners is not borne out by a quantitative analysis of the lifetime impact of the regime. The Society has estimated the overall effective rate of tax relief on lifetime pension savings, allowing for the tax relief on savings and the tax payable on pension income in retirement, taking account of the tax thresholds for persons aged over 65 and the impact of the tax-free lump sum that can be taken from overall retirement savings at the point of retirement. Details of the assumptions underlying this analysis are set out in paragraphs 8 and 10.

7. The results of our analysis are set out in Table 1 below. The results indicate that the current system gives the highest rate of income tax relief to people whose earnings are not too far above the threshold for the higher rate of income tax and who are saving a moderate amount for retirement. Notes on the individual scenarios illustrated are set out in paragraph 9 overleaf.

Table 1

Annual salary €	**Pension savings as % of salary**	**Overall effective rate of tax relief**	**Notes (see para. 9 overleaf)**
25,000	20%	23%	(a)
45,000	20%	40%	(b)
100,000	20%	31%	(c)
200,000	20%	22%	(d)
45,000	25%	34%	(e)

8. The model is based on a 40 year old man who saves 20% of salary per annum until age 65[8]. It is assumed that, at age 65, he takes the maximum tax-free lump sum of 1.5 times salary and purchases an annuity with the balance. It is assumed that he survives until age 85. Our model calculates the present value of the tax relief on pension contributions and offsets against this the present value of income tax paid in retirement on the pension annuity. The model assumes that current exemption limits, tax-bands, etc. increase annually in line with wage inflation.

9. Notes on the projections are as follows:

   (a) An individual earning €25,000 per annum before retirement will pay no income tax in retirement.

   (b) The maximum effective rate of tax relief on pension savings applies to an individual with an annual salary of €45,000. Contributions benefit from relief of income tax at 41% and PRSI at 6%. In retirement, income tax will be paid at the standard rate on approximately 25% of the pension annuity, with no tax payable on the balance.

   (c) At higher salary levels, the effective rate of tax relief is lower. An individual earning €100,000 per annum obtains income tax relief at 41% and PRSI relief at 2%[9]. During retirement, he or she will be liable for income tax at the standard rate on most of the pension annuity and just starts to break into the marginal tax bracket.

   (d) An individual earning €200,000 has a lower effective rate of tax relief than an individual earning €25,000.

   (e) For an individual earning €45,000, the effective rate of tax relief falls from 40% to 34% if the level of pension contribution is 25% of salary rather than 20% of salary. Essentially, the higher the level of pension contribution, the lower the rate of relief, as the rate of tax payable on the marginal pension resulting from the extra savings is higher than the average rate of tax on the overall pension.

10. The model assumes a modest rate of investment return (5% per annum); this is also the rate used for discounting purposes. Wage inflation is assumed to be 3% per annum. If higher rates of investment return and wage inflation are used, the effective rate of tax relief is somewhat lower. This is because the resulting pension is higher and is therefore subject to a higher overall tax rate. Table 2 overleaf shows the effective rates of tax relief assuming investment return of 7% per annum and wage inflation of 5% per annum.

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[8] Broadly speaking, an individual starting to save for retirement at age 40 would need to make contributions at this level (or higher) in order to target a pension of 50% of salary inclusive of the State retirement pension.

[9] The model ignores the slightly higher PRSA contribution rate applicable to salaries above €96,250.

Table 2

Annual salary €	Pension savings as % of salary	Overall effective rate of tax relief
25,000	20%	22%
45,000	20%	38%
100,000	20%	27%
200,000	20%	22%
45,000	25%	33%

11. While our analysis belies the view that the current system is of most benefit to high earners (in terms of net tax relief as a percentage of earnings), it indicates that the current system does entail significant effective rates of tax relief. For example, the availability of a tax-free lump sum is an attractive feature in terms of encouraging people to save for retirement, but has a significant cost in terms of its contribution to the effective rate of tax relief, in particular for higher earners. To illustrate this, Table 3 below shows the estimated effective rates of tax relief if no tax-free lump sum is taken.

Table 3

Annual salary €	Pension savings as % of salary	Overall effective rate of tax relief (if no tax-free lump sum is taken)	Overall effective rate of tax relief (including tax-free lump sum -Table 1)
25,000	20%	22%	23%
45,000	20%	35%	40%
100,000	20%	22%	31%
200,000	20%	14%	22%
45,000	25%	30%	34%

This form of analysis could similarly be extended to consider the impact of other potential changes to the current tax system, including, for example, reducing the earnings cap for tax relief on pension contributions (currently €275,237) or removing the higher income tax exemption limits that apply to people over age 65 (currently €20,000 for a single person or €40,000 for a married couple compared with €5,210 and €10,420 respectively for people under age 65).

Capped matching contributions

12. Various parties have made the case for the provision of capped matching contributions for pension savings, similar in structure to those granted under Special Savings Incentive Accounts (SSIAs). The Society acknowledges that some people may find it difficult to understand the tax incentives for pension savings. We agree that the high take-up of SSIAs suggests that a similar system of matching contributions for pension savings could help to improve the level of pensions coverage, provided that any proposed product structure was practicable and economic to deliver. We note, however, that it is unlikely that the same take-up rate could be achieved for retirement accounts as for SSIAs for several reasons, including the fact that pension savings would have to be committed for much longer periods and should normally be invested in riskier assets than the cash-based assets that appealed to most SSIA-holders. We note also that dismantling the current system of tax reliefs in favour of capped matching contributions would present very significant logistical complications.

Pre-retirement access to funds

13. The Society believes that allowing the option of pre-retirement access to funds on a restricted basis would provide a major boost to long-term saving. The success of SSIAs supports this premise. A corresponding offset against tax-free cash at retirement could potentially be applied

Approved Retirement Funds (ARFs)

14. The Society's view is that the option to transfer pension savings to an Approved Retirement Fund at the point of retirement should be extended to all members of all defined contribution arrangements. It is inequitable to require some members of such plans to purchase an annuity at retirement, regardless of annuity costs at the time, while exempting others from the requirement. However, current tax anomalies should be addressed. In particular, as any money in an ARF has received income tax relief, we believe that such money should be subject to income tax when withdrawn from the ARF. ARFs should not be passed to estates as low-taxed inheritances.

15. The need for, or appropriateness of, ARFs under defined benefit schemes is less clear-cut, given that the primary *raison d'etre* of such schemes is to provide a specified level of retirement income. There may be an argument for extending ARFs to defined benefit schemes in the interests of a level playing field between defined benefit and defined contribution plans in terms of benefit options. However, if ARFs were to be extended to defined benefit schemes, a number of issues would need to be carefully considered first, such as the implications for funding strategies and investment strategies and the basis on which guaranteed pensions would be converted to lump sums.

16. At present, there is a requirement for an individual effecting an ARF to have a guaranteed income of at least €12,700 or to place €63,500 in an Approved Minimum Retirement Fund (AMRF). The Society recommends that the latter test should be abolished - the primary requirement is to ensure that the individual concerned has a minimum guaranteed income, and, in any event, an AMRF of €63,500 is of much lower value than a guaranteed income of €12,700 per annum. We also consider that the minimum income test should be indexed to ensure that it maintains its value relative to increases in earnings.

Phased retirement

17. Current Revenue rules do not permit the phased payment of retirement benefits. We suggest that the rules be amended with a view to facilitating phased retirement. Pension scheme members should be allowed the facility to draw a partial pension while continuing to work part-time.

END