National Pensions Review

Submission by the Society of Actuaries in Ireland

August 2005

Introduction

The Society welcomes the opportunity to make this submission to the National Pensions Review.

This submission has been prepared by a working party established for this purpose and reflects the views of members of the Society as expressed at a consultation meeting on the Review.

Our submission focuses on the following aspects of the review:

1. Progress towards coverage targets
2. Adequacy of pension savings
3. Initiatives to improve voluntary pension provision
4. Alternative pension systems
5. Retirement ages and trends
6. State annuity fund

1. Progress towards coverage targets

The coverage target set by NPPI was 70% of the work force over age 30, with interim targets of 62% 5 years, and 66% 10 years, after implementation of the NPPI proposals, from a base of 54% in 1995. In practice, implementation of the NPPI proposals (in particular, the introduction of PRSAs) took some time to achieve and progress toward the NPPI coverage targets has been relatively modest. Coverage for those over 30 rose from 57.4% in 2002 to 59.1% in 2005.

As PRSAs have only been available for eighteen months, it could be argued that it is too early to judge whether the coverage target can be achieved by the current strategy. It is notable also that when PRSAs became available, SSIAs were, and still are, fully absorbing many people's capacity to save.

Notwithstanding these points, however, our view is that the NPPI coverage target will not be met unless there are much more radical changes and, in particular, significant further simplification of current structures. Our proposals in this regard are set out in section 3.

2. Adequacy of pension savings

In addition to concerns about coverage, the adequacy of current pension provision is a matter for significant, and growing, concern.

Those covered by defined benefit arrangements are generally adequately provided for, but there is a growing trend away from defined benefit towards defined contribution provision. The rates of contribution generally paid to defined contribution schemes, personal pensions and PRSAs are much lower than those required to provide what members are likely to consider an adequate pension.

The issue of adequacy is closely allied to pensions awareness, which is discussed further in section 3. In particular, there is evidence to suggest that people generally underestimate their life expectancy in retirement and, consequently, the level of savings required to provide an adequate pension. Continuing increases to life expectancy are likely to exacerbate this problem:

Projected life expectancy for an individual attaining age 65 in:	Man	Woman
2001	18.3	21.3
2020	20.3	23.1
2035	21.1	23.9
2050	21.7	24.4

An imminent paper from the Society's Defined Contribution Subcommittee suggests that an individual retiring at age 65 needs to target a retirement fund of ten times' salary in order to provide a pension of 50% of salary. This simple target is easier to explain than target funding rates. People can see easily that over a forty year working lifetime this requires a significant contribution rate – closer to 25% than 10%. They can also allow for other assets that they may have, for example, investment property. It would be helpful if this simple methodology were to be adopted widely as a way of educating people about the real cost of pension provision.

3. Initiatives to improve voluntary pension provision

3.1 PRSAs

PRSAs are a welcome addition to the range of pension products available to employers and employees. In particular, the availability of a regulated contract-based product rather than a trust-based product is likely to be increasingly attractive. However, the addition of a new pension product complicates the pensions market, and we suggest that differences between the different products should be reduced. In particular, the following should be considered:

- There should be similar tax treatment for employees' and employers' contributions.
- Approved retirement funds (ARFs) should be available to defined contribution schemes and buy-out bonds.
- There should be no restrictions on transfers to PRSAs from other products.
- There should be similar rules for signing-up employees into PRSAs and defined contribution schemes.

We would emphasise, in particular, the need for major simplification of the regulatory regime:

- to facilitate easier access to PRSAs
- to encourage a broader range of providers into the PRSA market.

3.2 Building on the success of SSIAs

SSIAs have proven that large numbers of people can be motivated to save if the product is sufficiently attractive and simple. It would be particularly useful to investigate how popular SSIAs have been among the target group that do not have pension savings, and we recommend that further research is carried out in this area.

We believe that the success of SSIAs can be attributed to the following:

- The simplicity and transparency of the top-up contribution from the Government (compared with tax relief on pension contributions).
- The shorter time horizon of the savings.
- The access to the savings if needed.
- The deadline by which the offer had to be accepted.

We suggest that consideration should be given to the introduction of a National Savings Scheme modelled on SSIAs, with a view to encouraging people to make long term savings, and thereby extending current pension provision through a substantially different route to current pension products.

It would be a challenge to replicate the SSIA model for a longer term savings contract. However, features of the SSIA model which could be included are as follows:

- The plan could operate over a series of five year terms.
- A top-up contribution could be made by the State in such a way as to encourage long term saving i.e. entitlement to the top-up would depend on the fund being carried forward at the end of five years as long term savings.
- The deadline for SSIAs could be replicated by opening the Savings Scheme to new savers only during a limited period each year.
- There would be no tax relief on contributions and investment growth would be taxed as for SSIAs.
- Contribution limits could be set at a similar level to SSIAs, as the primary aim would be to attract a modest level of long term savings from those who do not use current pension savings vehicles and are perhaps unlikely to do so.

At retirement, the plan proceeds would be available to the saver in lump sum form.

3.3 Tax relief

We suggest that current pension savings vehicles would continue to exist alongside the National Savings Scheme. Tax relief at marginal rates should continue, as pension savings amount to a deferral of income.

Some reform of the taxation of pension savings could be considered. Changes to the earnings cap for tax relief on contributions, the rules for tax-free lump sums and the taxation treatment of ARFs could be investigated, with a view to potentially funding some of the incentives for the National Savings Scheme.

We note, however, the need for particular care in any restructuring of the tax incentives for pension provision. Too much change over the short term could destroy confidence in the stability of the system, which is an essential factor in encouraging people to save over the long term.

3.4 Pensions awareness

Much more remains to be done in relation to raising people's awareness of the need to save for retirement. We believe that this needs to be a key priority on an ongoing basis and that significant resources will need to be allocated to it.

There may be scope to build on the work that is currently being done by IFSRA in relation to developing financial planning education programmes.

3.5 Defined benefit schemes

Whilst defined benefit provision is on the wane relative to defined contribution provision, it continues to form a very substantial proportion of total Second Pillar pension savings. Defined benefit schemes are under significant financial pressure, due, in particular, to historically low interest rates and increasing life expectancy. The pressure on such schemes is likely to increase if interest rates remain at current levels. The regulatory regime for defined benefit schemes needs to be as supportive as possible, in light of the difficulties faced by such schemes, in order to encourage the continuation of defined benefit provision, whilst balancing the need to safeguard members' accrued benefit entitlements.

While we welcome the adjustments that have already been made to the regulatory regime, we suggest a number of further changes:

- We believe that the current wind-up priorities provide a disproportionately high level of protection to pensioners, particularly when compared to older or long-serving active members. We have suggested previously that consideration should be given to some form of "levelling-up" i.e. giving the same level of priority as pensioners' benefits to an element of the benefit entitlements of other classes of members, in particular for those approaching retirement age.
- We believe that schemes should be allowed to substitute index-linked pension increases with appropriate fixed rate increases in the event of their winding-up.
- We suggest that consideration be given to broadening the powers and remedies available to the Pensions Board in circumstances where a scheme cannot meet the funding standard and cannot put in place a satisfactory funding proposal.
- Consideration could be given to allowing defined benefit schemes to make transfer payments to retiring members in lieu of their pension entitlement, perhaps in excess of a specified minimum pension, with members then being allowed to invest the transfer payment in an ARF. If such transfer payments were permitted on an "ongoing" basis, rather than on the basis of annuity rates, this could significantly enhance the continued viability of such schemes.

Consideration would need to be given to the extent to which member consent would be required for the making of such transfer payments.

Employers should consider, and the regulatory environment should facilitate, the redesign of defined benefit schemes to better suit current conditions, for example, lower rates of guaranteed benefits (whilst still perhaps targeting current benefit levels), retirement ages gradually increasing over time, benefits defined in lump sum terms rather than pension terms. Currently, employers are more likely to switch from defined benefit to defined contribution than to restructure their defined benefit schemes. Given the typical rates of contribution paid to defined contribution schemes, this trend increases our concerns in relation to the adequacy of current pension provision.

3.5 Approved retirement funds (ARFs)

Whilst we have proposed above that ARFs should be made available to members of defined contribution schemes, we are concerned that many retirees may not have sufficient information or expertise to plan adequately for the use of their retirement funds over their remaining future lifetime. In particular, there is a risk that those who live substantially longer than the average may run out of funds. This is an issue that needs to be addressed within pensions awareness and financial planning education initiatives.

In addition, appropriate controls are needed to ensure that the potential for funds to be exhausted early is limited. At present, there is a requirement for an individual to have a guaranteed income of at least €12,700 or to place €63,500 in an Approved Minimum Retirement Fund (AMRF). It would be appropriate to review these controls at this stage. The Society has recommended previously that the latter test be abolished i.e. an individual would only be able invest his or her pension savings in an ARF if he or she has a guaranteed income above the specified threshold. We also recommended that the minimum income test should be reviewed regularly to ensure that it maintained its value relative to earnings.

4. Alternative pension systems

The current strategy, as recommended by NPPI, combines a First Pillar pension designed to provide a basic minimum income guarantee together with provision for, and encouragement of, voluntary Second Pillar provision to enable individuals to achieve their desired level of income replacement in retirement.

We are of the view that this strategy continues to be an appropriate one. However, as outlined in section 3, we believe that there are significant changes that could be made to improve the chances of achieving the desired level of provision.

In advance of further potential improvements to the regime for voluntary supplementary pensions, we believe that it is too early to judge whether the NPPI targets for coverage and adequacy can be met by the current First Pillar / Second Pillar combination. Our view is, therefore, that it is too early to consider any increase to the level of mandatory pension contributions.

In the event that, a higher level of mandatory contributions is considered desirable, our view is that a mandatory Second Pillar system would not be desirable and that it would be preferable to enhance First Pillar provision by increasing the State pension or collecting mandatory contributions through the PRSI system. It would be preferable that any enhancement to First Pillar provision be pre-funded.

5. Retirement ages and trends

As noted above, life expectancy in retirement has increased substantially and is likely to continue to do so. The issue of the age at which people retire therefore deserves consideration. The feasibility of later retirement depends on whether longer life expectancy is associated with greater health in old age. In general, the available evidence suggests that longer life expectancy is likely to be associated with later onset of disability. This suggests that for many people later retirement may be feasible.

Currently, most people are unlikely to consider it desirable to postpone retirement beyond 65; rather, the trend in recent years has in practice been in the opposite direction. Ultimately, however, it may not prove affordable for people to have twenty to twenty-five years of retirement (perhaps more if medical science progresses at a pace faster than expected) after forty or fewer years at work.

In time, perhaps, it may be appropriate to consider determining the State pension age based on an accepted proportion of total life expectancy to be spent at work, so that the State pension age could - very gradually – increase in line with life expectancy (if this were the case, it might be considered appropriate to allow individuals to continue to retire at age 65 on an actuarially reduced State pension.

As a first step, however, our view is that flexibility needs to be provided, so that people can remain at work past age 65, if they want or need to do so. An enhanced State pension should be available to those who defer taking it for a period after age 65, and employers should be encouraged to take on, or continue to employ, older workers.

We recognise that there are many challenges and issues to be addressed in formulating a successful policy to encourage later retirement. This is an area that requires further research and analysis.

6. State annuity fund

We note that proposals have been made that the State should take on a role in the issuing of annuities. In particular, it has been suggested that the State should enable defined contribution members and PRSA holders to convert their retirement funds to a pension to supplement their State pension, within certain limits.

We agree that this should provide an attractive option to such individuals and should consequently encourage further pension savings. We note, however, that many retirees appear to prefer, insofar as is possible, to keep their retirement funds in lump sum form, so that the availability of State annuities may not have as great an impact as might be hoped.

We note, also, that a significant number of technical issues arise in relation to this proposal and that it therefore requires substantial further study before making a decision to proceed. In particular, we note that, in practice, it may not be possible for the State to offer annuities at rates that are significantly better than those currently available from commercial insurers, if the proposed fund is to operate on a cost-neutral basis and investment and longevity risks are fully factored in. We note, however, that a decision could be taken, if it was considered desirable for social policy reasons, to offer “below cost” rates.