REPORT OF THE WORKING GROUP ON THE REVIEW OF INVESTMENT AND BORROWING BY PENSION FUNDS

TO THE MINISTER FOR SOCIAL AND FAMILY AFFAIRS,

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Chapter 1

Introduction

1.1 The Social Welfare and Pensions Act 2005 provides for the transposition of EC Directive 2003/41/EC on the activities and supervision of Institutions for Occupational Retirement Provision (IORPs). This Directive provides a framework for the operation and supervision of occupational pension schemes and allows IORPs established in one EU Member State to be sponsored by employers in another Member State.

1.2 Article 18 of the Directive provides that the resources of a pension scheme must be invested in accordance with the "prudent person" principle. In particular, it provides that assets should be predominantly invested on regulated markets and diversified in such a way as to avoid excessive reliance on any particular asset. Article 18 also requires Member States to prohibit the institution from borrowing other than for liquidity purposes and on a temporary basis.

1.3 Article 5 of the Directive allows for an exemption from any of the provisions of the Directive for small schemes with less than 100 members (not including pensioners).

1.4 Section 33 of the Social Welfare and Pensions Act 2005 implements the requirements of Article 18 relating to investments, the detail of which will be set out in Regulations. Section 36 of the Social Welfare and Pensions Bill 2005, <u>as published</u>, implemented Article 18(2) of the Directive relating to borrowing and prohibited schemes from borrowing (taken to be direct borrowing undertaken by the scheme post implementation) in all circumstances other than for liquidity purposes.

1.5 Following the publication of the Bill, the Minister for Social and Family Affairs received many representations and there was much media comment in relation to the section 36 prohibition on borrowing. The broad thrust of the comment was that the Minister should allow borrowing for investment purposes for certain small schemes, mainly single member schemes.

1.6 In order to allow time for reflection and further discussion, the Minister introduced an amendment at the Report Stage of the Social Welfare and Pensions Bill 2005, the effect of which is that the Minister could, by Regulation allow direct borrowing for investment purposes subject to any appropriate restrictions and conditions.

1.7 The prohibition on borrowing set out in section 36 of the Act relates to direct borrowing entered into by the trustees of a scheme. Prior to the Finance Act 2004, Revenue approval of a pension scheme for tax relief purposes would not have been given if the scheme rules permitted direct borrowing. Section 16 of the Finance Act 2004 provided that a rule of a scheme permitting direct borrowing would no longer prevent a scheme from being approved or lead to a cessation of approval.

1.8 However, prior to the 2004 amendment, schemes could borrow indirectly by, for example, investing in a pension policy with a life company which undertakes the borrowing or in an unauthorised exempt unit trust[1] where the trust undertakes the borrowing. These options for indirect borrowing are still available along side the facility for schemes to borrow directly. As risks to the investor arise whether the borrowing is undertaken directly or indirectly, it is necessary to examine both types of arrangement.

1.9 To examine all of these issues more thoroughly, the Minister established a working group chaired by his Department and comprising officials from the Department of Social and Family Affairs, Department of Finance and the Revenue Commissioners together with representatives from the Pensions Board, the National Treasury Management Agency and the Financial Regulator. The membership of the group was:

Anne Vaughan, Department of Social & Family Affairs (Chair)
Geraldine Gleeson, Department of Social & Family Affairs
Karen Cullen, Department of Finance
Eamon Phelan, Department of Finance
Brian McCabe, Revenue Commissioners
Clive Slattery, Revenue Commissioners
Ian Woods, Pensions Board
Terry Murphy, Financial Regulator
Ronan O'Connor, National Treasury Management Agency
Dave Keogh, Department of Social & Family Affairs (Secretary to the Group)

1.10 The group met on four occasions between April 2005 and July 2005 and this is the report of their examination. There were also a number of bilateral meetings between the Department of Social and Family Affairs (D/SFA) and members of the group. The views of the group were presented to the Minister in September 2005 in the context of the implementation of the IORPs Directive by the 23rd of September 2005.

<u>Terms of reference</u>

1.11 The terms of reference of the group were:

"to examine all issues relating to borrowing and investment rules for schemes with less than 100 members taking into account the statements made by the Minister during the passage of the Bill and since in various fora, the representations made to the Minister from interested groups and individuals and the views of the Pensions Board as advised to the Minister.".

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[1] *An unauthorised exempt unit trust is a unit trust which is exempt from certain Revenue reporting requirements and is not authorised under the Unit Trust Act 1990.*

Scope of report

Prudential issues only

1.12 Having regard to the terms of reference, the group examined whether they should address both prudential issues and tax relief issues. In its advice to the Minister for Finance in December 2004, the Pensions Board advised that the borrowing prohibition in Article 18(2) of the Directive should be implemented for both prudential and taxation reasons.

1.13 In examining this issue, D/SFA was informed by the Department of Finance that, in the context of the Minister for Finance's Budget 2005 announcement of a review of tax expenditures and exemptions, it is also proposed to review the usage of pension tax reliefs by high earners.

1.14 To avoid unnecessary overlap and duplication, it was decided by the D/SFA that this group would limit the scope of their work to the prudential issues which arise in relation to borrowing and investment.

Range of schemes to be examined

1.15 Also having regard to the terms of reference, the group examined whether different issues arise for -

- single member schemes where the member is a trustee or has discretion as to how the assets are invested (e.g. letter of exchange arrangement),
- schemes with more than one member but where all the members are trustees, and
- multi member schemes run by a board of trustees on behalf of the membership.

Single member schemes [2]

1.16 It was decided that single member schemes (i.e. schemes which have been established for one person only) where the member is also a trustee or where the member has discretion as to how the assets are invested are distinguished from all other arrangements as, in such cases, the issues of duty of care which may arise are different.

Schemes where all members are trustees or have discretion as to how assets are invested

[2] *This would include single member SSASs and single member insured schemes.*

1.17 Such arrangements differ from the single member arrangements in one key respect, that is each member/trustee must act in concert and this may mean that any particular person in that group may exert undue influence which might serve to undermine the interests of one member/trustee as against another's. For this reason the Group decided that these schemes should not be distinguished from any other multi member scheme.

Trustees running a scheme on behalf of members

1.18 Where a scheme is established along traditional lines with a board of trustees running the scheme on behalf of a broader membership, it was decided that the same prudential issues arise for such a scheme as arise for a similar arrangement with more than 100 members. The group decided therefore at the outset, that these schemes should not be distinguished in any way from analogous schemes with more than 100 members.

Borrowing for investment in property pension arrangements

1.19 While borrowing may be undertaken for any pension investment, our understanding is that the vast majority is undertaken for investment in property and this review therefore concentrated on such arrangements.

Methodology

1.20 The group examined the body of regulation which applies to pension schemes which borrow (directly or indirectly) to invest in property and identified gaps in that regulation.

1.21 The group then examined whether prudential issues arise for single member schemes taking into account

- the body of regulation already applicable.
- the views of the Pensions Board.
- the submissions from the Association of Pensioneer Trustees (APTI) and a working party, established for the purpose of setting out the views of segments of the pensions industry, both of which set out the arguments against applying the borrowing and investment restrictions in Article 18 of the Directive and other representations from individuals and members of the pension industry.
- Work undertaken by Technical Guidance Ltd at the request of the D/SFA in relation to the technical aspects of the various options and the functioning of the market in relation to those products.

1.22 The group met with the APTI and the working party to discuss the issues arising.

1.23 Finally the group examined three options and these are set out in Chapter 5 of this report.

Chapter 2

Geared pension property arrangements – and current regulatory environment

Background to geared pension property arrangements

2.1 While there are no accurate figures available, anecdotal evidence suggests that there has been a marked increase in interest among what could be loosely called the "self employed" (proprietary directors and professional self-employed) in geared pension property arrangements over the last 3 to 5 years. There are a number of factors which have driven this increase including -

- the exceptional fall in global equity markets over a number of successive years,
- the introduction in 1999 of the Approved Retirement Funds (ARFs). These are investment funds in which certain individuals can invest the proceeds of their pension fund on retirement.
- a predisposition among the self-employed to invest in property allied to a substantial increase in the supply of geared pension property schemes as providers saw the increased demand for same.
- a strong view in the marketplace that it is, in certain circumstances, more tax efficient to buy a property as a pension arrangement than it is to buy it personally outside a pension arrangement.

Schemes which invest in geared property arrangements

2.2 The geared pension property investments have been availed of mainly by SSASs or single member insured pension arrangements where the member can control the investments of the scheme. Under Revenue rules a self administered occupational pension scheme with less than 12 members will generally be regarded as "small".

2.3 While traditional arrangements, i.e. where a board of trustees administer a scheme under trust for the members of that scheme, can invest in geared property arrangements, it is understood that it is to the single member/ SSAS arrangements that many of the products are marketed.

2.4 Representations received by the Minister characterise this group as high net worth individuals who are financially astute, can afford financial advice and who wish to control their own investments. However, as indicated to the working group, some products are available to investors with €50,000 to invest, which indicates that the market can also be aimed at middle income investors.

Arrangements for investment in geared pension property vehicles

2.5 The group understands that there are a number of different ways in which the trustees of an occupational pension scheme might invest in geared property investments as follows:

- direct investment by the scheme trustees in a specific property, funded partly by borrowing undertaken directly by the scheme trustees.

- investment by the scheme trustees in a collective investment fund which groups a number of different investors together to invest predominantly in a specific property or a portfolio of properties, funded partly by borrowing undertaken by the fund.

2.6 The main types of collective investment funds which might be used in this regard include:

- a life company pension property unit fund
- an unauthorised exempt unit trust
- an authorised collective investment fund (not being a UCITS)[3]
- a Common Contractual Fund (not being a UCITS)[4]

- direct investment by the scheme trustees in the shares of :

  - a private company (usually established in a foreign jurisdiction) set up specifically to purchase a specific property or properties (also usually located in a foreign jurisdiction) for that scheme, funded partly by borrowing undertaken by the company, or

  - a PLC (usually established in a foreign jurisdiction) set up specifically to purchase a specific property or properties (also usually located in a foreign jurisdiction) for that scheme, funded partly by borrowing undertaken by the company.

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[3] UCITS stands for Undertakings for Collective Investment in Transferable Securities. A UCITS established and authorised in one EU Member State can be sold to residents of other EU Member states without requiring separate authorisation from each State in which it wishes to operate. UCITS funds can not invest directly in property.

[4] *A common contractual fund is a form of collective investment fund where all of the investors are joint legal owners of the fund's assets. A non UCITS version of the CCF is provided for in the Investment Funds, Companies And Miscellaneous Provisions Bill 2005.*

Current regulatory environment

2.7 The following table sets out the variety of regulation which applies currently in respect of each of these arrangements. The table sets out the requirements -

(a) at the level of the provider

(b) at the level of the product

(c) in relation to advice regarding the sale of the product, and

(d) under Revenue rules.

Table. Summary comparison of regulatory requirements applicable to different ways by which pension schemes trustees might invest in geared property investments

Investment by scheme trustees	Prudential regulation by Financial Regulator of provider	Regulation of product	Regulation of advice provided in relation to product	Revenue regulatory and practice restrictions
In specific property, partly funded by borrowing undertaken by trustees	• No. • However intermediary who offers to arrange the loan for scheme trustees may be required to be authorised by the Financial Regulator or the Office of the Director of Consumer Affairs under the Consumer Credit Act, 1995 as a mortgage or credit intermediary, respectively.	• None	• None in relation to property investment • Mortgage lenders and mortgage intermediaries may be required to comply with the Financial Regulator Code of Conduct and information disclosure provisions of Consumer Credit Act in relation to arrangement and provision of a loan to trustees, in certain circumstances.	• Scheme must be '*"bona fide established for the sole purpose of providing relevant benefits"* • Borrowing by trustees subject to Revenue Pensions Manual restrictions. (e.g. non recourse borrowing) (See *Appendix* 1) • SSASs must have an independent professional trustee (See Appendix 2) • SSASs subject to restrictions on the type of property investment which are allowed. (See Appendix 3)
In pension policy whose value is linked to units of a geared property unit fund operated by a life company	• Yes. Life company established in the State is prudentially regulated by the Financial Regulator.	• No specific regulatory requirements applicable to the way in which insurers operate unit funds. • Life Assurance (Provision of Information) Regulations do not apply to policies issued to the	• Intermediary providing advice to trustees in relation to purchase of insurance policy must be authorised under the Investment Intermediaries Act, 1995. • Intermediaries subject to	• Scheme must be '*"bona fide established for the sole purpose of providing relevant benefits"* • SSASs must have an independent professional trustee (See Appendix 2) • Where unit fund

Investment by scheme trustees	Prudential regulation by Financial Regulator of provider	Regulation of product	Regulation of advice provided in relation to product	Revenue regulatory and practice restrictions
		trustees of occupational pension schemes. Hence they do not receive statutory disclosure of charges and sales remuneration.	Financial Regulator Code of Conduct requirements in relation to provision of such advice. However this may not apply to advice provided to certain scheme trustees. • Intermediaries subject to European Communities (Insurance Mediation) Regulations, 2005	links trustees investment to a specific property then all dealings in that property must be at arms length. (See Appendix 1)
In (un)authorised exempt unit trust	• No, on the basis that the trust is not available for investment by the 'public'.	• None.	• It is not clear whether an intermediary providing advice to trustees in relation to purchase of units in a unit trust must be authorised under the Investment Intermediaries Act, 1995. Where there is doubt, the Financial Regulator recommends that schemes/ firms obtain legal advice. • Intermediaries subject to the Financial Regulator Code of Conduct	• Scheme must be '*"bona fide established for the sole purpose of providing relevant benefits"* • SSASs must have an independent professional trustee (See Appendix 2) • Where unit trust links trustees investment to a specific property then all dealings in that property must be at arms length. (See Appendix 1)

Investment by scheme trustees	Prudential regulation by Financial Regulator of provider	Regulation of product	Regulation of advice provided in relation to product	Revenue regulatory and practice restrictions
			requirements in relation to provision of such advice. However this may not apply to advice provided to certain scheme trustees.	
In Collective Investment Fund (non UCITS) • *a unit trust authorised under the Unit Trust Act, 1990* • *an investment company authorised under the Companies Act, 1990, Part XIII* • *an investment limited partnership, authorised under the Investment Limited Partnership Act, 1994*	• Yes.	• Yes, by Financial Regulator through a series of notices which cover investment and borrowing restrictions and disclosure of information. • However these restrictions do *not* apply to funds which are: ○ marketed only to professional investors, which could include pension scheme trustees, or ○ investment companies which are not open for investment by the public	• Intermediary providing advice to trustees in relation to investment in any of these collective investment schemes must be authorised under the Investment Intermediaries Act, 1995. • Intermediaries subject to the Financial Regulator Code of Conduct requirements in relation to provision of such advice. However this may not apply to advice provided to certain scheme trustees.	• Scheme must be '*"bona fide established for the sole purpose of providing relevant benefits"* • SSASs must have an independent professional trustee (See Appendix 2) • Where fund links trustees investment to a specific property then all dealings in that property must be at arms length. (See Appendix 1)

Investment by scheme trustees	Prudential regulation by Financial Regulator of provider	Regulation of product	Regulation of advice provided in relation to product	Revenue regulatory and practice restrictions
In Common Contractual Fund (non UCITS) *(provided for in Investment Funds, Companies and Miscellaneous Provisions Bill, 2005.)*	• Yes	• Likely to be similar Financial Regulator restrictions as apply currently to Collective Investment Funds (non UCITS)	• None.	• Scheme must be '*"bona fide established for the sole purpose of providing relevant benefits"* • SSASs must have an independent professional trustee (See Appendix 2) • Where fund links trustees investment to a specific property then all dealings in that property must be at arms length. (See Appendix 1)
In shares of a foreign <u>company, (private or PLC) which in turn borrows</u> and invests in a specific property or properties	• No.	• None • However content of prospectus for investment in a PLC may be subject to Regulations.	• Intermediary providing advice to trustees in relation to purchase of transferable shares must be authorised under the Investment Intermediaries Act, 1995. • Intermediaries subject to Financial Regulator Code of Conduct requirements in relation to provision of such advice. However this may not apply to advice provided to certain scheme	• Scheme must be '*"bona fide established for the sole purpose of providing relevant benefits"* • SSASs must have an independent professional trustee(See Appendix 2) • SSASs subject to restrictions on investment in shares of private companies. However these do not apply to companies set up specifically to enable scheme trustees to invest in domestic or

Investment by scheme trustees	Prudential regulation by Financial Regulator of provider	Regulation of product	Regulation of advice provided in relation to product	Revenue regulatory and practice restrictions
			trustees.	overseas properties

Issues in relation to current regulation

Regulation of provider by Financial Regulator

2.8 The Financial Regulator regulates providers of life company unit funds. This is an undoubted general consumer protection in that it protects the solvency of these institutions. The trustees and managers of collective investment schemes are vetted and approved by the Financial Regulator.

2.9 However, trustees of unauthorised exempt unit trusts are not subject to the Financial Regulator's regulation on the basis that the trust is not available to the public. Much of the geared property investment by small self-administered schemes is by way of either direct or indirect investment in unauthorised exempt unit trusts and these are actively promoted to individual proprietary directors in their capacity of both trustee and investor.

2.10 The contention that these trusts are not available to the public in relation to single member schemes (see recommendation below in relation to regulation of the product), may not reflect the de facto position, where these products are being made available to members of the public through single beneficiary trust arrangements.

Regulation of product

2.11 There are strict prudential rules laid down in relation to investment in collective investment schemes (CISs) which set out, inter alia, detailed investment and borrowing rules. (However funds which qualify as "qualifying investor funds" receive derogation from the borrowing and investment rules.)

2.12 In relation to investment in life company unit funds there are no requirements relating to borrowing limits or concentration of investments or risk.

2.13 There is no direct product regulation in relation to direct investment in a property or unauthorised exempt unit trusts. The rationale for the lack of regulation in relation to unauthorised exempt unit trusts is that they are not available for participation by the public, as they are marketed solely to institutional investors such as pension schemes.

2.14 While there appear to be inconsistencies in the regulation of these products, what is consistent is that there are little or no statutory information requirements or investment restrictions where they are marketed to institutional investors. However, it is likely that when these exemptions were established, the growth in single member arrangements which has taken place since 1999 was not envisaged. The group considers that there would now seem to be a strong argument that these single member investors should not be treated in the same way as other institutional investors as these individuals are in fact the same as any other member of the public and should therefore be afforded the same protections.

2.15 Nonetheless, the group recognise that this is a very complex area and that any proposal the group might make could have unintended effects. For example, if the group were to recommend that unauthorised exempt unit trusts should require authorisation if they market to single member schemes, then this could distort the market in favour of life company unit funds. If the group were also to recommend that life company unit funds be subject to the Financial Regulator's borrowing and investment requirements relating to authorised unit trusts where they deal with single member investors, this could have unintended effects for these funds and, in any event, the extent to which the market could design products to get around these restrictions would also need to be examined. Given the complex and technical nature of these issues, the group considers that they should be examined in the context of a broader review of this whole area by all the relevant agencies.

Marketing & promotion of property

2.16 Property is not a regulated market so no specific regulatory provisions apply to the marketing and promotion of property to pension scheme trustees. The group discussed whether they should recommend that where property is marketed for pension purposes it should be regulated. However, it was considered that it would be extremely difficult to administer partial regulation of this area and almost impossible to enforce.

Provision of information

2.17 Policies issued to trustees of an occupational pension scheme are not subject to the Life Assurance (Provision of Information) Regulations, 2001, and hence such trustees are not statutorily entitled to receive disclosure of benefits, charges and sales remuneration related to a pension policy they may invest in. However, in the normal course trustees could require such disclosure as a condition of doing business and so the group does not recommend any change in this area.

Regulation of advice

2.18 There is significant regulation with regard to the provision of advice where an individual invests in a geared property arrangement (i.e. indirect borrowing).

Financial Regulator code of Consumer Protection

2.19 Intermediaries authorised under the Investment Intermediaries Act must comply with the Financial Regulator's code of conduct in relation to the provision of advice. Therefore, advice given by such an intermediary to a trustee who is investing in an insurance policy, a UCITS, or a private company is governed by that code of conduct.

2.20 However, the proposed revised Financial Regulator Consumer Protection Code applies only to dealings with customers who are not deemed to be professional investors. The definition of professional investor includes the term "pension fund". The requirements of Chapter 2 of that code relating to investments may apply to professional investors but the issue is still under consideration by the Financial Regulator and the finalised position will not be agreed for some time.

2.21 The group recommends that the Financial Regulator Consumer Protection Code should apply to the single member schemes to which this report refers.

Intermediaries providing advice

2.22 It is not clear whether an intermediary providing advice to trustees in relation to the purchase of units in an unauthorised exempt unit trust must be authorised under the Investment Intermediaries Act, 1995. In cases of doubt the Financial Regulator recommends that schemes/firms obtain legal advice.

2.23 The group recommend that this issue be clarified, if necessary by way of amendment to the Investment Intermediaries Act, 1995.

Revenue rules

2.24 There is some consumer protection in Revenue rules where a scheme borrows directly to invest in property. To the extent that there is significant diversification of the assets concerned, the requirement that the lending institution can only have recourse to the asset in respect of which the money is borrowed provides some protection for the scheme's investments.

2.25 These Revenue restrictions, applied via Chapter 5.5 of the Revenue Pensions Manual, apply only to borrowing undertaken directly by the scheme. The group examined whether these conditions, in particular the requirement that any loan should only have recourse to the asset in respect of which the borrowing is undertaken, should be applied also to indirect borrowing effected through unit funds and unauthorised exempt unit trusts.

2.26 On examination, the group found that in such circumstances the borrowing is legally undertaken by the Life Company, unit trust trustees or Investment Company, as the case may be, and is therefore already non recourse to the pension scheme investor. On this basis the group agreed not to recommend any change.

2.27 Revenue also require a pensioneer trustee to be appointed in some cases (small self-administered schemes) which, apart from ensuring that Revenue regulations and requirements are adhered to, adds a layer of protection in that the pensioneer trustee must be prudent in his/her dealings with and advices to the individual.

Conclusion

2.28 The group considers that there is a significant body of regulation in place in relation to providers, the various products and the provision of advice. However, many of the protections are designed for consumers and do not apply to single member pension schemes. The group do not consider that, when derogations were introduced for institutional investors, it was intended that these would apply to these single member schemes. The group therefore recommend that this issue be examined as part of a broader review of the regulation of single member investors.

2.29 However, this is not to say that there are no protections in place for these schemes. In particular the group noted the non recourse aspect of all borrowing. Where the borrowing is undertaken directly, Revenue rules require that it is non recourse other than to the asset in relation to which the borrowing is undertaken. To the extent that scheme assets are diversified, non-recourse borrowing provides some protection for scheme investments. Where it is indirect, it is non recourse to the investor as it is the fund or trust which legally undertakes the borrowing. To the extent that an investor has diversified his or her pension provision, this provides some protection.

2.30 In addition, while in some circumstances various protections cannot be directly compared, they are nonetheless valuable. For example, where the borrowing is undertaken indirectly, there are significant requirements in relation to advice (subject to clarification of the Financial Regulator consumer protection code), whereas with direct borrowing there is a Revenue requirement in relation to SSAS's to have a pensioneer trustee, who must under trust law act prudently in the interest of the member.

Chapter 3

Examination of prudential issues

3.1 In the course of the passage of the Social Welfare and Pensions Bill 2005 through the Oireachtas, and since its enactment, the arguments for and against the imposition of the borrowing restriction have been made and can be summarised as follows;

Arguments for implementing the investment and borrowing restrictions

3.2 The Pensions Board recommended to the Minister for Social and Family Affairs that the exemption allowed in Article 5 of the Directive should not be availed of in relation to the prohibition on borrowing in Article 18(2). The basis for this view taken by the Pensions Board was that:

- Borrowing by schemes is not consistent with the essential nature of retirement savings whereby a fund is built up over time by the accumulated contributions of employers and, in some cases, employees, together with the investment return thereon (this constitutes the accepted understanding of saving for retirement provision);

- The addition of investment based on gearing increases the risk element thereby reducing the security of members' benefits (the level of risk increasing in line with the level of gearing);

- The scope to borrow may lead to an undue level of investment in a single asset class (e.g. property) and an undesirable concentration in the scheme's portfolio thus further compromising member security.

- If the IORPs Directive sees fit to ban borrowing for large schemes it would seem illogical to allow it for a single member scheme which would be less well able to absorb the higher investment risks.

3.3 The Financial Regulator endorses the position of the Pensions Board. Borrowing, whether direct or indirect, in order to leverage investments, increases the volatility of return and thus risk for the investor. The objective of a pension scheme should be the prudent management of the funds accumulated with a view to maximising return within an overall objective of ensuring the safety of the investments and their availability on the retirement of the member. Encouraging unlimited borrowing, direct or indirect, within a pension scheme would not appear consistent with that objective.

3.4 Other views articulated were -

- while many who borrow to invest in a geared property plan are high earners who are well informed, own the company which has established the scheme and can afford the appropriate investment advice, there is a danger of leakage to less well informed middle income investors who might not feel they can afford to take financial advice. There is also a danger of leakage to the AVC[5] market.

- property is not a regulated market and the purpose of regulation is to reduce risk to participants.

- while geared pension investment is in practice confined to property there is a danger of leakage to equity investment which can also be volatile in the short term.

- Property is an illiquid asset and geared property schemes do not seem to factor in the possibility of a member becoming ill and unable to work where the individual may require immediate access to funds.

Arguments against implementing borrowing/investment restrictions

3.5 The arguments set out below have been made mainly in representations from individuals and representative groups in relation to this issue. The main points raised in support of applying the exemption under Article 5 of the Directive to single member schemes are that:

- There is no need to protect a person from him/herself.

- Investment in property is a viable long-term option capable of matching returns from equity investments.

- Restricting borrowing would mean smaller pension funds would be at a disadvantage and would be restricted to smaller investment portfolios.

- As 83% of all Irish schemes are single member schemes, any prohibitive regulations could impact pension coverage.

- The operation of SSASs is already well regulated by Revenue and such schemes are required to appoint an independent pensioneer trustee to ensure compliance with Revenue rules and restrictions.

- Prohibiting direct borrowing would be a reversal of the provision introduced in 2004 under the Finance Act. The purpose of that amendment was to level the playing pitch as between investing directly in property and investing indirectly through unit fund or unit trust arrangements, often through life companies. Many representations argued that the indirect option is a much more expensive option.

- Individuals want to provide for their retirement independently and want control over the choice of investment.

[5] *Additional Voluntary Contributions.*

Discussion of Group on Prudential Argument

General Discussion

Borrowing per se

3.6 In general the group agreed that borrowing per se is not a bad thing and that borrowing allows a scheme to maximise its investment potential. Indeed arguments have been made that a prohibition on borrowing would adversely affect the smaller investor who would necessarily be restricted to smaller investment. However, borrowing increases risk and the higher the borrowing the more acute the risk, notwithstanding the view that the higher the risk the higher the potential return. Borrowing exaggerates the returns on the upside and the losses on the downside. For example, if a scheme borrows 70% of the purchase price of a property and the value of the property decreased by 30%, the equity may be lost and the property may have to be liquidated. Therefore, the higher the level of borrowing the greater the risk there is that all equity invested in the property may be lost.

Direct and indirect borrowing

3.7 In relation to a particular property, the impact for the individual is effectively the same whether the borrowing is made directly by the pension scheme or indirectly through investment in a packaged product. For example, if the value of the property in which a scheme invests falls by 10%, then where the scheme borrowed directly the value of the asset falls by 10%, and where the scheme borrowed indirectly the value of the units fall by 10%. Therefore, the group considered that any recommendations in relation to direct borrowing should be mirrored, in as far as possible, in relation to indirect borrowing.

3.8 However, it may be misleading to consider that there is no difference between direct and indirect borrowing because in the indirect borrowing case it is more likely that the investment will be in a spread of properties, which in turn leads to a greater spreading of risks compared with direct investment in a single property.

Diversification

3.9 The risk associated with borrowing to invest is exacerbated where the scheme has not diversified its investment. Diversification reduces risk by avoiding over exposure to a single asset class or to a single asset, notwithstanding any non-recourse requirement in respect of borrowing. Where individuals have invested in geared property as their sole pension investment, they could be left with nothing if the value of a property were to fall substantially and the credit institution were to foreclose. In particular, the Pensions Board consider that the risk associated with geared investment in a non-diversified property asset in a single member scheme gives rise to the likelihood that, at some point, one or more of these schemes will collapse exposing their holders to either:

- partial loss of retirement provision (where other assets/savings exist), or
- total loss (apart from Social Welfare provision) of retirement provision (where no other assets/savings exist).

Arguably, the potential adverse impact is less readily absorbed in a one-member than in a multi-member arrangement especially where no other assets exist. The Financial Regulator considers a lack of diversification in an investment portfolio also increases risk by exposing the entire portfolio to a single asset or asset class and the impact on that class of a unique market event.

The group viewed this as a real risk in light of the fact that some of the current investment is in property abroad where little may be known about the schemes on offer.

Potential leakage

3.10 In relation to potential leakage to less well informed investors, the group considered that there are dangers here as such investors may not be aware of the risks associated with geared property, or indeed the extent of hidden charges. The group heard anecdotal evidence in relation to "ordinary" self-employed individuals being offered packaged geared property investment products. The group also understand that there are packages available to investors who have capital of as little as €50,000. The main concern of the group in this regard would be the potential for misselling.

Discussion of the group of arguments against implementing borrowing/ investment rules.

3.11 In relation to some of the arguments advanced in representations to the Minister, the group had the following observations:

Should the State protect an individual from him/herself?

3.12 The group was of the view that the State's interest in single member pension schemes where the member is a trustee or sole investor relates to -

- the need to ensure tax reliefs are used appropriately for the purposes intended (this will be examined as part of the review of the use of pension tax reliefs by high earners being undertaken by the Department of Finance and Revenue), and

- the need to ensure adequate, secure and sustainable pensions in retirement.

3.13 Prudence can be defined as the exercise of good judgment, common sense and even caution in practical matters. A legal dictionary defines it as "attentiveness to possible hazard or caution or circumspection as to danger or risk.". The argument made in the representations to the Minister is that once an individual is aware of the risks then that person's own views, beliefs and circumstances should drive that person's investment decisions. Personal choice and control should be unfettered.

3.14 However, in the context of ensuring adequate and secure pension provision and bearing in mind the significant value of tax reliefs, the group was of the view that they could not ignore the probability that in the absence of any limitations and bearing in mind the "gaps" in the current regulatory environment, there will be imprudent investment, misinformation and misselling and that these issues should be addressed. The simple reality is that currently there are individuals who are very highly invested in geared property and have no other pension provision and this could not be regarded as prudent by any objective standard. Also, the Financial Regulator considers that we need to bear in mind that apparent official endorsement of certain practices, specifically permitting unlimited borrowing within a pension scheme, and the provision of favourable tax treatment in respect of such practices may lead to imprudent investment decisions

Performance of property as a long term asset

3.15 Many of the representations referred to the fact that property is a tangible asset, that it is a viable long term option that will perform at least as well as equities. The following table[6] compares Irish equity and property percentage returns over the 5, 10 and 20 year periods to 2003.

Years to end 2003	5	10	20
	%	%	%
Equities	2.3	13.1	15.3
Property	16.1	19.0	13.3

3.16 As these figures show, property has tended to generate a relatively high income return and the view of the group is that it is a suitable long term asset and certainly has a place in a balanced pension portfolio. However, in common with other markets the property market fluctuates (in each of the three year periods 1984 to 1986 and 1991 to 1993, cumulative capital values fell by approx 15%.).

[6] *Article by Frank O'Brien, Irish Pensions Magazine, November 2004.*

The coverage argument

3.17 On the question of coverage, it is argued in representations to the Minister that 83% of Irish pension schemes are single member (Pensions Board Annual Report 2003) and that any undue or unnecessary additional regulation could severely impact the extension of coverage in this category.

3.18 At the end of 2004, one-member only schemes registered with the Pensions Board represented 78% of all (defined benefit and defined contribution) schemes. An analysis of the Board's register shows that the average number of single member (non group) defined contribution schemes commenced in each of the 6 years since 1999 has increased by 32% (to 8,010 per year) when compared with the 6 years prior to 1999 (6,060 per year). The figures for SSASs (many of which may also be single member schemes and as such would be included in the figures above) show an average of 388 schemes commenced per year since 1999 as against 26 per year in the 6 years prior to 1999. The number of SSASs commenced in 2004 more than doubled (930) as against 2003 (407).

3.19 It is clear that there has been a significant increase in the average number of single member (non group) defined contribution schemes commenced in the last six years and an even more marked increase in the SSASs. However, what is not clear is whether this growth can be attributed to any great extent to the availability of geared property as a pension option. The increase may be explained partly by a natural growth in pension coverage as the market in Ireland develops and partly by the introduction of the Approved Retirement Fund (ARF) facility in 1999. Nonetheless, the increase in SSASs since 2004 coincides with the change in the Finance Act of that year related to pension borrowing.

3.20 Also, it should be borne in mind that while 78% of all schemes are one-member only schemes, their membership represents only 9% of total membership of occupational pension schemes. Therefore the potential for a change in membership of such schemes to significantly affect overall coverage (in either direction) should not be exaggerated.

Borrowing to invest is already regulated in a variety of ways

3.21 Many of the representative groups also made the case that there is already sufficient regulation of these schemes from a variety of sources in particular, the Revenue and the Financial Regulator. This issue is examined in Chapter 2 and some recommendations are made in relation to the issues relating to the current regulation.

3.22 While the Pensions Board and Financial Regulator do not support any exemption from the provisions of Article 18, the discussion outlined above indicates that an approach is needed that would limit the potential for overexposure to risk while keeping to a minimum any impact on pension coverage, choice or control and which does not unnecessarily add further regulation.

Chapter 4

Options examined by group

4.1 Bearing in mind the discussion outlined in Chapter 3, the group examined three broad options in relation to single member schemes.

- Option 1– Apply all the requirements of Article 18 of the Directive to all schemes regardless of size;

- Option 2 – Exempt single member schemes from the requirements of Article 18 of the Directive but impose some restrictions such as a cap on the level of borrowing whether direct or indirect and/or a requirement for diversification;

- Option 3– Exempt single member schemes from all the requirements of Article 18 of the Directive.

Option 1

Apply all the requirements of Article 18 of the Directive to all schemes regardless of size:

4.2 Other than the ban on direct borrowing, the requirements of Article 18, which could have the most potential to impact negatively on the facility for single member schemes to borrow, are the requirements to be predominantly invested on regulated markets and to be diversified.

4.3 The group was of the view that the imposition of all of the requirements of the Directive would address the concerns outlined in Chapter 3 and the Pensions Board and Financial Regulator support this option. Nonetheless the following reservations were expressed in relation to this option;

- This option would require direct borrowing to be prohibited entirely which could potentially mean a return to the pre 2004 situation where schemes could borrow indirectly but not directly.

- With respect to indirect borrowing for investment in property, as property is not a regulated market, the requirement to be predominantly invested on regulated markets would almost certainly mean that the majority of existing geared pension property products would not comply with this requirement.

- This could also mean that investment in a single property would become “unattainable” to the small investor, who would be precluded from investing more than 50% of his/her assets in such a market ("predominantly" is taken as being >50%).

- There is also the question of whether pensions coverage could be affected. However, as shown in the statistics provided by the Pensions Board, there are insufficient data to prove or disprove this argument.

- Another concern would be that the imposition of the "regulated market" rules would lead to a trend towards investment in geared products other than property (such as equities) where investors want to maximise their investment potential. Therefore while severely restricting investment in property which is considered an "appropriate" investment as part of a balanced portfolio, the application of the "regulated market" rule could potentially encourage investment in geared assets such as equities which are volatile. However, there is also a view that credit institutions may be reluctant to lend to the same extent for non property assets.

- The requirements of Article 18 are applied at scheme level. This does not recognise the reality of individual pension provision which is often spread across a range of schemes or personal plans. It may be inflexible to apply all these requirements at scheme level for personal pension provision. However, it may also be impractical and potentially unenforceable to apply them at individual level.

- Finally, this option does not take account of the body of regulation already in place in relation to these schemes albeit that regulation is not consistent across the range of options available, as already discussed in Chapter 3.

Option 2

Exempt single member schemes from the requirements of Article 18 of the Directive but impose some restrictions such as a cap on the level of borrowing whether direct or indirect and/or a requirement for diversification.

Cap on borrowing

4.4 In relation to direct borrowing, a cap could be imposed as a percentage of the gross assets of the scheme (i.e. the assets of the scheme plus any money borrowed). The group discussed a possible cap of 50% of gross assets. The effect of this would be that a scheme could only ever borrow an amount equivalent to its net assets (i.e. assets before borrowing). For example a scheme with assets of €50,000 could borrow €50,000 and a scheme with assets of €100,000 could borrow €100,000. This means that even if a scheme then invested all the assets in a property fund, the ratio of the loan to the value of the property could never be more than 50%.

4.5 In relation to indirect borrowing the cap could be imposed as a requirement not to invest in geared pension property products where the gearing exceeds 50%. In this way there would be a level playing pitch as between direct and indirect borrowing.

Views of industry representatives

4.6 This issue was discussed with APTI and the working group established to represent the industry. In essence the industry representatives consider that the non recourse nature of the lending means that credit institutions must necessarily act prudently in lending on such a basis and, in practice, would very rarely lend in excess of 70% of the property value. Therefore the view of the industry representatives is that this is operating as a de facto limit on borrowing at the moment. Nonetheless, they would not favour the imposition of an actual cap as they would be concerned that such a rule would be inflexible as there may be some instances where it would be appropriate for an institution to lend more. As they see it, the current regime offers a flexible way of imposing a limit and this flexibility in their view is in line with the Government’s regulatory reform programme.

4.7 The point was also made that, as the current effective limit is set at 70% of the value of the property, the property purchased would have to fall by 30% before the capital investment would require liquidation (if at all) and falls in property values of that magnitude are rare. Indeed, even if the property did fall in value to this extent, the lending institution would be happy as long as the debt is serviced. The comment was made that the only scenario in which a property investment could be in serious trouble would be if –

- The property dropped in value
- It could not be rented , and
- The member lost his/her job and was unable to re-pay the loan

4.8 The industry representatives also consider that the industry has a professional responsibility to ensure that the investment is prudent.

Views of working group

4.9 Notwithstanding the view of the industry representatives, in principle, the group consider that a cap on both direct and indirect borrowing would reduce risk while minimising adverse impacts. While the group acknowledge that the non recourse nature of the lending is a significant protection, they nonetheless consider that if a cap on borrowing is desirable it would not be sufficient to rely on the perceived prudence of lending institutions in order to achieve it.

4.10 In relation to the comments of the industry representatives that property investment could only be in serious trouble in specific circumstances, the working group considers that circumstances outlined are far from impossible over the lengthy periods of time involved in pension investments and that less stressful circumstances could nonetheless lead to significant losses within a scheme.

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Implementation/ enforceability of borrowing cap

4.11 The group then discussed the question of the implementation and enforceability of such a cap. A cap on direct borrowing would be enforceable as it relates to borrowing undertaken directly by the scheme. The scheme is regulated by the Pensions Board and as part of its normal scheme review programme the Board would check whether this requirement had been observed in an appropriate sampling of cases.

4.12 On the other hand, the cap on indirect borrowing would be very difficult to implement/ enforce for a variety of reasons, not least the fact that unauthorised exempt unit trusts are not subject to regulation. Therefore neither the Pensions Board nor the Financial Regulator would be in a position to accurately or independently determine the gearing content of a particular property fund.

4.13 In the circumstances, enforcement of cap in relation to investment in such schemes might not be enforceable. Other practical difficulties would also arise, such as whether the cap would apply at the overall fund level or at sub fund level. It would be difficult to deal with layered arrangements.

Other options to achieve a cap on indirect borrowing

4.14 Given the potential difficulties outlined above relating to implementation/ enforceability of a cap on indirect borrowing, the group explored whether there are other ways to achieve the same outcome and which would not require ascertaining and independently verifying the precise level of borrowing in a property fund.

4.15 They considered the imposition of a cap on the net value of scheme assets which could be invested in a geared pension property fund. The option was linked to net assets so as to avoid a situation where a person could borrow directly to invest in a geared property fund. (*See Appendix 5 for details of option examined.)*

4.16 However, the option could create differences as between the direct and indirect borrowing. For example, under the direct borrowing option, a scheme could borrow the amount of its net assets and invest all the assets in a property. In this way the loan to value of asset ratio is capped at 50% but there is no requirement to diversify. Under the indirect borrowing option which was examined, the scheme cannot invest all its net assets in a geared property and so there is a built in requirement to diversify, however the loan to value of asset ratio could be much higher than 50%.

4.17 While this option has merit in that it would reduce the risk associated with investment in geared pension property by requiring a degree of diversification, there is concern that taking a different approach to reducing risk depending on whether the borrowing was undertaken directly or indirectly could have unintended effects. For example, it could skew the market in favour of direct borrowing and could introduce additional complexity for consumers.

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Diversification

4.18 The group also examined the question of imposing a requirement for all schemes to diversify.

Views of industry representatives

4.19 The industry representatives had the following to say regarding diversification. Revenue rules require that the debt is discharged within 15 years and often the debt is discharged in less. Full debt discharge opens diversification as an option.

4.20 There would be technical difficulties associated with a diversification requirement at the level of the scheme. For example, an individual (a company director for example) who has one pension policy is currently prohibited by Revenue from transferring a portion of that fund to another life company. The entire policy must be transferred or none at all. This would greatly restrict an individuals ability to diversify her/his pension assets, were s/he to be forced to do so. In a scenario whereby a person was forced to diversify, s/he would rightly argue that s/he was impeded in his investment choices due to not being permitted to effect partial transfers.

4.21 Most investors are on their second or third pension investment when they invest in a property and the majority of them are experienced investors. It is unlikely that anyone in a small scheme would start off with a large investment in geared property.

4.22 If diversification is imposed, the assets in which the scheme is forced to invest (to achieve diversification) may prove to be the wrong investment strategy.

4.23 Any diversification should be applied at the level of the individual rather than the scheme. It is entirely usual for individuals to have more than one "pension pot" and any realistic diversification requirement would have to take this into account.

4.24 The ability to borrow gives a person more options and facilitates diversification.

Views of working group

4.25 The group believe that diversification reduces risk. However, the group accepts that, particularly in the single member market, any requirement for diversification should ideally be imposed at the level of the individual rather than at the level of the scheme.

4.26 As pointed out, single member schemes are often self-employed individuals who may have a variety of pension savings arrangements and could therefore be argued to be unrealistic and inflexible to require diversification at the level of the scheme when the individual has more than one "pension pot". This will not be the position in all cases.

4.27 However it was also accepted by the group that the imposition of any requirements at the level of the individual would be extremely difficult, if not impossible, to enforce and therefore of little value in practical terms.

<u>Option 3</u>

Exempt single member schemes from the requirements of Article 18 of the Directive;

4.28 This option would retain the status quo (pertaining since the Finance Act 2004) for single member schemes.

4.29 While this option would not address the concerns outlined in Chapter 3, it is acknowledged that the current regulatory regime has allowed the development of the current market where individuals can invest in geared property for the purpose of a pension.

4.30 As recently as 2004 changes in the Finance Act of that year allowed for schemes to borrow directly and remain approved by Revenue.

4.31 In Chapter 2, the Group has highlighted issues in relation to this regulatory regime.

4.32 The Pensions Board point to a concern that this option exposes individuals to the risk of entering into investments unsuitable and imprudent in their circumstances pending completion of the regulatory framework.

<u>Conclusions</u>

Options explored

4.33 Option 1 would address all of the concerns raised by the Pensions Board and Financial Regulator but restrict the freedom of schemes to invest to the best of their ability and would seem to run counter to the policy changes in the 2004 legislation.

4.34 Option 2 would go some way to addressing the concerns of the Pensions Board and Financial Regulator and would address the concerns articulated by the group in general. However, this option raised many difficult and complex issues in relation to the treatment of direct and indirect borrowing, which it was not possible to address in the time available.

4.35 Option 3 maintains the status quo (pertaining since the Finance Act 2004) and allows time for a fuller examination of the broader regulatory regime. However it does not resolve the concerns articulated by the group in general, particularly the Pensions Board and Financial Regulator.

Proposals

4.36 On balance the group considers that the provisions of article 18 should be applied in full to all schemes with more than one member (paragraphs 1.17 and 1.18).

4.37 The issues highlighted by the group in relation to the current regulatory environment as it applies to single member schemes, and in particular, their treatment as institutional investors, are of significance and should be examined as part of a broader review (paragraphs 2.7 to 2.30).

APPENDIX 1.

Revenue Pensions Manual

Investments

5.1

The sole Revenue interest in scheme investments is to ensure that schemes are "bona fide established for the sole purpose of providing relevant benefits", Section 772(2)(a). Certain investments may prevent approval or prejudice ongoing Revenue approval. These could include investments used for tax avoidance purposes and assets not used to provide "relevant benefits".

Borrowing

5.2

Section 16 Finance Act 2004 provides:

"A retirement benefits scheme shall neither cease to be an approved scheme nor shall the Revenue Commissioners be prevented from approving a retirement benefits scheme for the purposes of this Chapter because of any provision in the rules of the scheme which makes provision for borrowing by the scheme".

The following rules apply to scheme borrowing:

1. Only assets purchased by borrowing may be used to provide security to the lender.

2. Assignment of rental income to the lender is not permitted

3. Life cover on the amount of the debt may only be provided outside the scheme.

4. No cross collaterisation.

5. Interest only loans and loans for a period of more than 15 years are not permissible. The loan should be repaid in full prior to normal retirement age.

6. Use of other scheme assets to clear residual debt is not permissible.

Geared Property Investment Vehicles.

5.3

In relation to investments made via geared investment funds and unit trusts, it is possible to link a scheme investment to a particular property, within a collective investment fund, provided the arms length rules apply. In other words, all acquisitions, disposals and lettings must be on a totally arms length basis.

APPENDIX 2

Revenue Pensions Manual

Pensioneer Trustee

19.2

The trustees must include a Revenue approved "Pensioneer Trustee". The duties of the Pensioneer Trustee are set out in the following undertaking that must be given:

" I undertake that in relation to any pension scheme, approved under the Taxes Consolidation Act 1997, of which I am a Trustee that I will:

(a) Not consent to any action which is contrary to any Revenue regulations. I will report immediately to Revenue full particulars of any action to which I am requested to consent which I consider may be contrary to Revenue regulations.

(b) Supply annual accounts, periodic actuarial reports, or any other information required by Revenue.

(c) Not agree to the termination of any scheme of which I am Pensioneer Trustee otherwise than in accordance with the terms of the approved winding up provisions.

Nor will I delegate powers to any other Trustee of such a scheme or to any outside person or body on behalf of any other Trustees so as to circumvent the foregoing undertaking.

I further undertake to advise Revenue immediately I cease to be a Trustee of any such Approved Scheme."

It is a precondition of Revenue approval that at all times the scheme must have a Revenue approved Pensioneer Trustee. The Trust Deed must provide that the Pensioneer Trustee cannot be removed without prior Revenue approval and that the Pensioneer Trustee must be a co-signatory on all financial transactions.

Prior to a resignation by a Pensioneer Trustee, it is the responsibility of the other Trustees to arrange for the appointment of a replacement. In cases where this does not occur within 30 days of a resignation, Revenue will withdraw approval from the scheme.

If the trust instrument establishing a scheme provides for the trustees to act on majority rather than unanimous decisions, this provision must be qualified so that it does not apply where the question for decision relates to the termination of the scheme.

It is clear from the above that quite onerous obligations are placed on the Pensioneer Trustee. These are in addition to the normal obligations that apply under trust law.

In order to qualify for Pensioneer Trustee status, the applicant must be widely involved with occupational pension schemes and their approval. Experience in processing approval of schemes, administration of small self-administered schemes and a good working knowledge of Revenue Practice, are necessary qualifications. Arrangements should be in place for the provision of a complete range of services: actuarial, legal, investment and administration.

Where a corporate body wishes to act as a pensioneer trustee, it is essential that the directors, or a majority of them, should be acceptable as pensioneer trustees in their own right. The directors regarded as acceptable should have the power to determine how the corporate body will vote in any proceedings of the pension scheme trustees.

Applications for approval to act as a Pensioneer Trustee should be sent to the Pensions Business Unit. The application should include a full "pensions C.V." together with details of any self-administered schemes established and administered by the applicant.

A list of Revenue approved Pensioneer Trustees is available on request.

APPENDIX 3

Revenue Pensions Manual

Investment of Funds in Small Self-Administered Schemes

19.4

All scheme investments must be on an arm's length basis. The investment powers of Trustees are circumscribed in a number of areas which are detailed below. The list is not exhaustive and is merely intended as a guide. A ruling on any specific proposal can be requested.

(i) Loans

Loans to members of schemes or to any other individual having a contingent interest in the scheme or to the employer are prohibited.

(ii) Property Investments

A proposal to acquire property as an investment can be approved subject to the following:

(a) The vendor is at arm's length from the scheme and the employer including its directors and associated companies;

(b) The purpose of the acquisition is <u>not</u> for disposal or letting to the employer, including its directors and associated companies;

(c) Disposal of the property is on an arm's length basis

(d) The scheme has sufficient liquid investments to ensure that the requirement to provide benefits can be met. Where the main or only asset is property, it is considered that the concentration of investments in an asset not readily realisable does not satisfy the overriding need to match investment of the assets with a scheme's liabilities with particular reference to the requirement to provide benefits. The situation could arise when the first or subsequent individual retirements take place that a scheme would be compelled to realise its only or main asset in order to comply with the requirement to provide benefits.

(e) The purchase of holiday homes is not permitted.

(f) Purchase of overseas property will only be permitted where there are appropriate arrangements in place to enable the Pensioneer Trustee to maintain control of the asset to ensure that Revenue rules are complied with.

(g) A transaction which involves the scheme trustees directly in the acquisition and development of property with a view to its disposal will not constitute an investment to which the exemption in Section 772 (2), Taxes Consolidation Act ,1997, will apply.

(h) Any proposal that involves the diversion of the sponsoring employer's taxable activity into the scheme is not acceptable.

(iii) Self-Investment

The following type of self-investment is *not acceptable:*

(a) Acquisition of property or other fixed assets from the employer

(b) Acquisition of shares debentures, etc. in the employing company whether by subscription, bonus issue or by purchase from existing shareholders or by any other means,

(iv) Pride in possession articles

Schemes are not permitted to invest in personal chattels such as works of art, jewellery, vintage cars, yachts etc. Schemes can invest in choses in action which are not tangible, moveable or visible. Examples are company shares, copyrights, and financial futures.

(v) Private Companies

Investments must be limited to 5% of scheme assets and to 10% of the private company's share capital.

Appendix 4

FINANCIAL REGULATOR NU Notice 18.3

COLLECTIVE INVESTMENT SCHEMES (OTHER THAN UCITS)

Property schemes

A collective investment scheme, which invests in property or property related assets, is subject to the following rules in addition to the general rules for all collective investment schemes which are not disapplied below.

"Property" is defined as a freehold or leasehold, with a minimum unexpired lease of seventy years, interest in any land or building.

"Property related assets" refer to securities issued by a body corporate (e.g. shares, debentures, warrants or certificates representing these) whose main activity is investing in, dealing in, developing or redeveloping property.

1. Before authorising the scheme, the Authority must be satisfied that the management company, general partner and/or, where applicable, investment advisory company, have specific experience in the area of investment in property.

2. The scheme may provide for the issue of partly paid units in the trust deed, articles of association or partnership agreement. The prospectus must fully disclose the nature of the commitment which investors will enter into. Where the scheme provides for partly paid units investment restrictions apply in terms of uncalled capital and net asset value combined.

Valuations

3. The management company of the scheme must appoint a qualified independent valuer or valuer(s) selected on a basis approved by the Authority. Details of the appointment(s) must be included in the prospectus and in the periodic reports issued by the scheme. The Authority must be notified in advance of a valuer's appointment and resignation.

4. The scheme must be valued at open market value at least twice yearly, with provision being made for more frequent valuations to be undertaken if market conditions warrant it. Issue and redemption prices must be made available after a valuation of the portfolio has taken place.

Investment Restrictions

5. Before a property is acquired for the scheme it must be valued. The valuation report must confirm that if the property was acquired for the scheme it could be disposed of at that valuation within a reasonable period. The property must be

acquired within six months from the date of the report and at a price which is within 5 per cent of the valuation price.

6. Property related assets must be traded in or dealt on a market which is provided for in the trust deed, articles of association or partnership agreement. However, up to 15 per cent of the scheme's net assets may consist of property related assets which are not traded in or dealt on such a market provided that these assets are acquired under the same conditions as for properties above.

7. Not more than 20 per cent of the scheme's net assets may be invested in any single property. This restriction is effective from the date of acquisition; however, a property whose economic viability is linked to another property is not considered as a separate item of property for this purpose. The scheme may derogate from this restriction for two years following the date of its launch provided it observes the principle of risk spreading. Schemes existing prior to August 1991, which had properties valued at more than 20 per cent of net assets do not have to dispose of such property.

8. There are no restrictions on the amount of cash or short term securities which can be held by the scheme when the purpose of such holdings is to meet redemption requirements or where this is otherwise reasonably necessary.

9. Not more than 25 per cent of the scheme's net assets may be invested in properties which are vacant, in the process of development or requiring development.

10. Not more than 25 per cent of the scheme's net assets may be invested in properties which are subject to a mortgage. (This provision does not affect the ability of a scheme to secure its borrowing generally on the properties of the scheme.) The amount of the outstanding mortgage on any property must not represent more than 50 per cent of the value of that property.

11. The scheme may not grant any person an option to acquire any property included in the scheme.

Borrowing

12. The scheme is allowed to borrow up to an amount equal to 25 per cent of the value of the net assets of the scheme, which borrowing may be generally secured on the properties of the scheme.

Redemption Procedures

13. The redemption procedure as described in the trust deed, articles of association or partnership agreement must be fully disclosed in a prominent position in the prospectus.

Other Requirements

14. The prospectus must contain a description of the risks involved in this type of scheme and a prominent risk warning which will make reference to circumstances in property markets which can cause difficulties in meeting redemptions .

15. The scheme must have reached a minimum viable size within a specified period after the launch. The minimum viable size and specified period must be defined in the prospectus. No property may be purchased or contracted until this minimum amount has been reached. In the event that the minimum viable size is not reached within the specified period, the scheme must return any subscriptions received to the unitholders and apply to the Authority for revocation of its authorisation.

Appendix 5

Proposed formula for dealing with indirect borrowing.

The following proposed formula imposes a cap on the amount that a scheme can invest in geared pension property but is also designed to deal with the interaction between direct and indirect borrowing.

The basic proposition would be :

- for every €1 of net assets in a scheme, the scheme can borrow in total a €1 for investment purposes.
- the scheme can 'spend' their borrowing allocation either in direct borrowing or in investment in geared property funds.
- a €1 invested in a geared property fund will be considered as €3 of borrowing (i.e. assumes 75% gearing within the fund), whatever the level of actual internal gearing in the fund.

To set this out in a formula would be :

- maximum investment in geared property funds = 33% of net assets
- maximum direct borrowing at any time = 100% of [Net Assets– 3 x value of investments in Geared Property Funds]

Example 1

Scheme has €300k net assets.
Maximum borrowing exposure = €300k
Max invested in Geared Funds of €100k, i.e. 1/3rd
Available limit for direct property borrowing = 100% x [€300k – 3 x €100k] = nil
Total assumed borrowing exposure of scheme = 3 x €100k = €300k.

Example 2

Scheme has €300k net assets.
Maximum borrowing exposure = €300k
Invested in Geared Funds : €50k, say
Available limit for direct property borrowing = 100% x [€300k – 3 x €50k] = €150k
Total borrowing exposure = 3 x €50k (geared property funds) + €150k direct borrowing = €300k total.

Example 3
Scheme has €300k net assets.
Maximum borrowing exposure = €300k
Invested in Geared Funds : nil, say
Available limit for direct property borrowing = 100% x [€300k – 3 x nil] = €300k
Total borrowing exposure = €300k direct borrowing.