Irish
Association
of Investment
Managers
35 Fitzwilliam Place
Dublin 2.
Tel (01) 6761919
Fax (01) 6761954
E-Mail: info@iaim.ie

Irish Association of Investment Managers

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

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Overview and Executive Summary

Chapter 1

The Irish Association of Investment Managers is pleased to submit its response to the Green Paper on Pensions. IAIM represents the leading fund managers in the Irish market.

Our response addresses each of the areas where the Green Paper poses questions. These are set out in the following chapters.

The Green Paper sets out the wide and complex issues involved in developing appropriate policy initiatives in this critical area of public policy. Despite the complexities the core issues can be summarised as:

- The cost of Tier 1 pensions will rise significantly as a percentage of GDP in coming decades. This can be funded through increased PRSI contributions now or in the future or some other form of exchequer funding must be identified.

- The provision of occupational pension schemes is in decline. In addition, it is anticipated that substantially all employees will move to DC schemes over the next 25 years. Adequacy of retirement provision is already emerging as a problem and, in the absence of action, will disimprove further.

In our submission we identify the ‘enhanced PRSA’ as an option suitable for those we know have insufficient or no pension savings. We believe that mandatory or soft mandatory systems will either fail to target the right employees or undermine the existing levels of retirement provision.

Others may disagree with our views, however we believe it essential that whichever measures are selected in all areas addressed must form a robust cohesive policy approach that will result in an overall improvement in the stock of retirement savings.

The Social Welfare Pension: *Reform Options*

Chapter 2

Questions Posed

1. In the light of the reforms to the Social Welfare system undertaken in the 1970s, 80s and 90s which will, in future, see most people qualifying for contributory pensions, are there implications for people who are at present not receiving support through the Social Welfare pension system?

2. Is the introduction of a universal pension arrangement a desirable and feasible option?

3. If universal provisions are not considered appropriate then what groups, if any, currently outside the Social Welfare pensions system should be targeted for action?

4. Policy in relation to pensions has, for many years, concentrated on improving the position of all pensioners. Is this the most appropriate way of improving pensioner incomes or should there be a more targeted approach using measures such as the Living Alone Increase?

5. If the basis of qualification for contributory pensions was changed from average contributions made, to one based on total contributions, what would be an appropriate level of contribution a person should be required to have to receive a full pension?

6. Should a formal indexing arrangement linking pensions to some level of prices, earnings or risk of poverty threshold be introduced?

   How would a formal indexation mechanism be operated having regard to the overall budgetary and economic position?

7. Given the issues raised in this chapter, in Chapter 3, and in the Green Paper in general in relation to the long-term affordability of existing arrangements, how can the challenge of the growing cost of Social Welfare pensions be addressed?

IAIM Commentary

A Social Welfare pension, the objective of which is to provide for a basic standard of living in retirement, is central to any policy for retirement support.

The existing system is understood, redistributive and possesses a high degree of fairness. In our view it's principal deficiency is the failure to automatically index the pension to either price or earnings increases.

As the Green Paper notes in the long term coverage is likely to rise to 98% of which only a small proportion will be entitled to a non-contributory pension.

The research conducted prior to the publication of the Green Paper highlighted:

- the cost of Tier 1 pensions is the largest component of the increased exchequer burden over time;

- the Social Insurance Fund will be exhausted within the next decade

There are only two options to address this increased cost:

- Increased contributions with consequential impact on competitiveness. Increasing the level of PRSI contributions is a step to be taken with caution given its likely impact on competitiveness. It is not an option to be recommended without a detailed understanding of all of the economic implications.

- Pre-funding of part of the anticipated future cost. Contemplating additional contributions to the NPRF in the present difficult climate should not deter examination of this option. Economic conditions will become more buoyant in the medium term. The current necessary infrastructure development with associated large capital expenditure, will be completed and more resources for the long term pre-funding of the Social Insurance Fund may be available. It could be possible to increase the current annual contribution to the NPRF or to provide for more flexible levels depending on budgetary performance.

Supplementary Pensions: *Incentives for Retirement Saving*

Chapter 3

Questions Posed

1. Can tax incentives be better targeted to encourage improved coverage in a cost-effective way?

2. Should the over-riding principle be coverage or equity and should incentives be offered at the marginal, standard or a hybrid rate?

3. Should pension arrangements (e.g. the ARF option) differentiate between individuals or be open to all on the same basis? Where is the proper balance to be struck between the competing calls for equitable treatment of all pensioners, appropriate protection for vulnerable pensioners and the costs involved?

IAIM Commentary

Much of the public commentary prompted by the publication of this Green Paper has focussed on the comparison of the cost of the incentives currently granted, the yield from pension benefits currently being paid and the cost of providing Tier 1 pensions at present. These are not of course comparable. Tax reliefs currently granted will, in future years, yield exchequer revenue as claimants reach retirement. The yield from pension benefits currently being paid relates to tax incentives granted in earlier years.

We understand that IAPF has commissioned independent research to model the overall net impact of tax concessions provided now and the related tax revenues when benefits are ultimately paid out. We urge that the research, which presents a significantly different picture be studied carefully.

It is clear, however, that any suggestion that switching this cost into the immediate increase of Tier 1 pensions is flawed.

Opinions on the incentives for retirement savings are linked to views on the best approaches to pensions development.

Ireland faces two challenges:

(a) To promote increased coverage, especially at an early stage.

(b) To ensure that retirement savings levels are adequate.

Data, on coverage, provided by the Department of Social and Family Affairs indicates that over 500,000 of those without pensions are employed in the retail, hospitality, construction and agricultural sectors. It seems appropriate that pension development initiatives and tax concessions acknowledge this cohort. These employments are often characterised by multiple employments, short term contracts and part-time work. Undoubtedly the Tier 1 pension may approximate 50% of pre-retirement earnings for some of these employees. However, for a significant proportion it will not.

Much of the literature on retirement provision highlights the behavioural aspects of individuals.

Entering into pension arrangements should be made easy and there should be some incentive. Education on the need for retirement provision is also a critical component.

We believe that two specific proposals merit attention.

- The option of the State matching Euro for Euro (up to a certain limit) the contributions of individuals to PRSA's is simple, easily understood and suitable for the earnings levels in these sectors and would build on the savings experience established by the SSIA initiative. As the Green Paper notes estimates of potential exchequer cost are tentative. However the capacity to taper the matching contribution would allow more targeting and a lower exchequer cost. This option could also incorporate other attractions to potential savers for example the inclusion by product providers of 'eco' or 'SRI' elements within the underlying assets which could address growing areas of interest.

- IAIM also believes that the encouragement of further 'Multi-Employer' schemes in these sectors should be examined. These have proved successful in Holland, Australia and New Zealand.

The research supporting the Green Paper indicates that a key driver of the lower then necessary savings rate is failure to start retirement saving at an early stage. The strong participation levels of the 20-29 age group in SSIA's gives comfort that an 'enhanced PRSA' properly marketed would entice earlier retirement savings.

Possible Approaches to Pensions Development

Chapter 4

Questions Posed

1. In light of the discussion in this Chapter, and giving consideration to the sustainability concerns raised in Chapter 3, is the current system of retirement provision, based on a combination of State provision through the social insurance system, and voluntary provision through occupational and other supplementary pension arrangements, appropriate? If the current system requires to be enhanced, should higher pensions be provided through social insurance or through supplementary provision or both?

2. If an enhanced supplementary pension approach to coverage and adequacy is preferred, should it be addressed through changes in the current voluntary system, or by way of soft mandatory or mandatory provision?

3. Can either a 'soft' or 'hybrid' mandatory pension scheme be designed to ensure that it would not operate to the detriment of the existing voluntary pension arrangements, for example by encouraging movement out of existing systems (which may be potentially better from the member's point of view) into any new mandatory arrangement?

4. How can the extra costs of enhanced provision be financed? Are improvements in pension coverage and adequacy through enhancement of the social insurance system and/or the introduction of a system of soft mandatory or mandatory pensions provision outweighed by the likely costs and economic impacts?

5. Is the introduction of either a 'soft' or 'hybrid' mandatory scheme a desirable option given the economic, financial and competitiveness implications of such systems?

IAIM Commentary

In our response to Chapter 7 of the Green Paper IAIM signalled its support for the 'enhanced PRSA' model as the most suitable to build both coverage and adequacy. The issue of mandatory enrolment requires to be addressed.

The introduction of mandatory or soft mandatory schemes are extremely expensive. Various reports of the Select Committee on Work and Pensions of the United Kingdom Parliament during 2007 dealt with this issue at length. The collection systems, administration, customer reporting etc. require significant expensive infrastructure. There are a series of other processes including the establishment of default options, the approval of authorised providers etc.

The experience of mandatory/soft mandatory arrangements in other jurisdictions are worth noting.

- In Australia, 16 years after the Superannuation Guarantee was introduced it is estimated that the savings rate should be increased by up to 6%. Only 20% of employees make voluntary contributions while 27% of employees receive employer contributions greater than the Guarantee level.

- In New Zealand, as the first anniversary of Kiwi Saver (a soft mandatory system) approaches over a third of the relevant employees have opted out. These are typically in sectors similar to those which must be targeted in Ireland.

- As the UK moves towards the full implementation of its mandatory personal accounts initiative research conducted on behalf of the Association of British Insurers suggests that up to 25% of existing pension scheme members will reduce their funding levels to the mandatory rate.

The objective of mandatory/soft mandatory arrangements must be to increase coverage and adequacy of provision. IAIM believes that soft mandatory systems introduced at significant cost, will not successfully target the specific cohort which currently has no pension provision.

Mandatory systems will undoubtedly increase coverage however there is strong evidence that this will undermine existing levels of retirement provision. Mandatory schemes also involve competitive issues.

It is our view that adopting such a wide ranging and complex initiative without determining whether other options targeted at these employees without, or with limited, pension provision might be successful is unwise.

Issues regarding Defined Benefit and Defined Contribution Pension Schemes

Chapter 5

Questions Posed

1. Are there problems with the current integration arrangements for DB schemes?

   If so, what are the possible solutions?

   a. Prohibit integration?

   b. Restrict a reduction in pensionable pay in the last, say, 3 or 5 years?

   c. Have a different integration formula for lower earners, as is the case in the public sector?

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

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

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

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

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

IAIM Commentary

1. <u>Integration Issues</u>

   Integration is an integral part of the design of virtually all DB Schemes. Any significant adjustment would have dramatic implications for an already expensive and potentially high risk obligation of sponsoring employers. In our view it would accelerate the move away from defined benefit schemes.

   The Green Paper does identify the difficulties posed by declines in pensionable pay in years close to retirement. This difficulty is generally recognised by, and addressed, by trustees.

2. <u>Guarantees, Security of Benefits and Pension Protection</u>

   It is not possible to completely eliminate risks from any pension scheme. Investment strategies may focus on minimising risk but this is at a cost of significantly increased contribution levels. It is our view that the existing regulatory environment facilitates identification of schemes with potential problems which can then be addressed. There are, however, some inflexibilities within current legislation which restrict the ability of trustees/sponsors to restructure schemes in difficulty. These should be re-examined.

   The sponsorship of DB schemes is a significant voluntary act. We believe that the options examined are more likely to lead to further closures of schemes and the reduction of benefits.

   The international experience of arrangements to meet scheme shortfall does not suggest to us, suitable models, which might be introduced in Ireland. We identify elsewhere the possible role for a State Annuity Fund to provide protection for DB members in the (expected) infrequent event of involuntary winding up.

   Despite the significant information provision requirements there is clearly a lack of understanding, by scheme members, of the different investment strategies, the risk characteristics of various asset classes and of asset allocation strategies. Further efforts to educate members may alleviate some, but not all, of the concerns about security of benefits.

3. <u>Education and Awareness</u>

   A core concern identified in the consultation process is the failure by individuals to start providing for their retirement at a significantly early stage in their working lives and subsequently to save at an inadequate rate. As we address more fully in our response to Chapter 8 of the Green Paper, there is a pressing need for further education and awareness about pension issues including an understanding of the interaction between contributions over time and achievable returns.

The Funding Standard

Chapter 6

Questions Posed

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

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

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

4. Should the funding standard remain unchanged?

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

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

IAIM Commentary

IAIM is in agreement with the OECD conclusion that the emphasis on a wind-up test (which requires schemes to be able to purchase annuities if they were to close immediately) does not properly reflect the future funding needs of pension schemes.

In essence the Standard interposes a hypothetical short term test into a long term investment process. The Standard is not used to ‘flag’ possible concerns about the assets of a scheme. Rather it triggers a significant and costly process for trustees and sponsors and may give rise to unnecessary concern amongst members. Volatility in asset values is an inevitable feature of long term investment propositions such as pensions.

Schemes which fail to meet the standard may not, having regard to the strength of the sponsor, revised investment strategies, consent of the members, require recovery plans.

Disclosure of any shortfall under the Standard coupled with the considered reasons why a recovery plan is not required is certainly an acceptable approach. A Standard which requires a recovery plan to address a problem which will not arise is flawed.

We are aware of strong views that existing wind up entitlements are inequitable. These should be re-examined.

Annuities and Related Issues

Chapter 7

Questions Posed

1. Do annuities offer value for money?

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

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

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

   For example:

   - Are there steps which could be taken to better inform customers in relation to the comparative cost of annuities?

   - Should providers be obliged to inform a prospective purchaser that their annuity can be bought from a different provider?

   - Should measures be introduced to encourage people to look at alternatives to fixed single life annuities?

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

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

IAIM Commentary

The issues in this consultation concerning annuities and the annuities market are the subject of considerable research. The National Pension Review included a report by Hewitt Associates which addressed possible state involvement while Indecon and Life Strategies have examined the requirements for certain DC holders to purchase annuities. The OECD examined “Policy Issues for Developing Annuities Markets” generally in a January 2007 paper.

The OECD paper highlights considerable deficiencies in annuity markets in most countries. There are complex supply side issues including pricing challenges, sensitivity to small adjustment to mortality assumptions, inability to fund assets appropriate to match liabilities, solvency requirements etc. On the demand side the complexity and lack of understanding of the products is a key issue. In an Irish context with a small market these global features are accentuated. It is our assessment that there is little prospect of encouraging new entrants into the market and increased competition and diversification are unlikely.

We believe that education about, and awareness of, annuity products can be improved particularly through targeted rather than generic information/advice. We see no impediment to the regular provision, by the Pensions Board, of suitable comparative annuity level data, on various bases.

IAIM strongly endorses the conclusions reached in the Indecon and Life Strategies report that there is no logical reason why retiring members of defined contribution schemes should be subject to different rules to those (including PRSA holders) who may avail of the ARF options.

Hewitt & Associates examined the various levels in which the State might participate through a State Annuity Fund. Their report identified two 'minimum proposals':

(a) Provision of pensions to retired members of DB schemes which are involuntarily wound up.

(b) Provision of a facility for the surrender of modest accumulated retirement funds in exchange for a guaranteed addition to the Social Welfare pension.

The first of these proposals, initially proposed by the IAPF, would facilitate the desirable objective of enabling more DB schemes to continue at the expense of modest or no State funding. The administration, trusteeship and fund management could be provided by private sector appointments the cost of which could be factored into the actuarial computation of the cost of benefits. The report noted identifiable benefits with minimal associated risks in respect of this proposal.

The second proposal, as noted by Hewitt & Associates, would involve the State in a more interactive role with retirees on a regular basis. This would require new administrative structures and costs which would have to be assessed before a conclusion could be reached.

The Role of Regulation

Chapter 8

Questions Posed

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

2. Are the regulatory objectives appropriate?

3. Is the level of regulation appropriate to the regulatory objectives we are trying to achieve?

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

IAIM Commentary

1. <u>Regulation: Objectives, Approach and Application</u>

   The Green Paper acknowledges that the legislative and regulatory framework within which pensions operate is complex.

   In general the State's regulatory objectives are appropriate. However, we have concerns about the regulatory burden imposed in achieving these objectives. For example, the Green Paper recognises that emphasis has been on disclosure of information to scheme members as a cornerstone of the regulatory process. There is ample evidence in other Chapters that members do not have the level of understanding necessary to evaluate key issues facing them. IAIM believes that the effectiveness of this level of information is limited.

   The current legislative structure provides limited scope for the application of regulatory requirements in a manner best suited to the differing schemes, products and other arrangements which prevail. We believe that a review of the legislation and the manner in which it is implemented is now appropriate. A suitable model for this review might be the Advisory Forum on Financial Legislation established in 2007. As part of its works the legislative principles will be established in primary legislation. The manner in which these principles are to be implemented will be incorporated in statutory instruments and finally detailed application (capable of facilitating application in a manner appropriate to different circumstances) will be by way of Regulatory Guidance.

   The establishment of such a forum, with representatives of key stakeholders would facilitate a redrafting of the legislative/regulatory provisions relating to pensions in a way that achieves the State's objectives but with an appropriate regulatory burden. This could facilitate, by agreement, the elimination of some, principally information disclosure, requirements which have little real value. Such an initiative could be implemented as a stand-alone project immediately.

2. PRSA Regulation

   The regulatory burden associated with PRSA's is, in our view, excessive and undermines a key objective of PRSA's which is the facilitation of retirement saving at lower levels. We believe the take up of PRSA's has been inhibited and there could be a reduction in available choice.

   It should be possible, as an urgent discrete exercise, to resolve this issue through consultation between the Board, Revenue, Financial Regulator, Product Providers, employee interests and the Department.

3. Pension Fund Charges

   The Green Paper discussion of 'Charges and Pension Products' is in our view misleading.

   Virtually all sponsored schemes have independent advisors who, inter-alia, design investment management mandates for a tender process. Invitations to tender are restricted to those firms who have a proven history of performance in the area covered by the mandate. Irish investment managers compete with overseas managers for all of these mandates and indeed there are significant mandates held by overseas managers. In such a competitive environment there is intense pressure on fees charged and no room for 'hidden charges'.

   In general the least sophisticated saver will consider the PRSA as the vehicle of choice and these are subject to statutory control.

   We have expressed our concerns about auto-enrolment/compulsory schemes in Chapter 4.

Public Service Pensions

Chapter 9

Questions Posed

1. How should the cost of funding public service pensions be met?

2. Which individual reform options offer the most realistic potential?

IAIM Commentary

The projected evolution of public sector pension costs are a significant component of the overall expected growth in the net exchequer cost of pensions. This is explored in detail in the Life Strategies/ESRI report incorporated in the National Pensions Review.

The final determination of public sector pension arrangements is a matter for settlement, through partnership, between the State, as employer, and public sector employees.

Given the importance of this component within the pension reform context there has to be a proper assessment of the appropriateness and cost of the various benefits and how they interact with levels of remuneration, job security and other working conditions. This assessment requires that that benefits be costed (some of which are rare and extremely expensive in the private sector) in the same manner as they are in the private sector. This data should be publicly available.

The availability of these assessments would facilitate more informed commentary on which of the reform options are more realistic.

The liabilities of the public sector should also be valued regularly and disclosed as part of the budgetary process. Consideration should be given to the accounting for unfunded benefits as part of Government debt (even in a pro-forma fashion). In an environment which will involve many calls upon Exchequer resources such disclosure would, at a minimum, highlight the importance of appropriating resources to address the funding gap.

Work Flexibility in Older Age: *A New Approach to Retirement*

Chapter 10

Questions Posed

1. Should measures be put in place to encourage later retirement? Should measures be put in place to encourage employers to retain older workers? What form should such measures take?

2. Should a system allowing for voluntary deferral of the Social Welfare pension be introduced? How should this operate?

3. Should other incentives be introduced to encourage people to work beyond normal retirement age?

4. In order to encourage later retirement, should employers be prohibited from setting a retirement age below a certain age? Should they be prohibited from setting any retirement age?

5. In order to contain costs and reflect increased life expectancy, should a change be made to the retirement age for Social Welfare pensions? How should such a change be implemented?

IAIM Commentary

A continued increase in longevity is not contested in any of the relevant research. Indeed the OECD (in a 2007 working paper) points out that past projections have consistently underestimated actual improvements in mortality rates and life expectancy. The increased burden on the public finances resulting from a significant decrease in the pensioner support ratio is not restricted to the Tier 1 pensions cost but will be accompanied by increases in healthcare and other age related expenditure. Over the time horizon contemplated by the Green Paper advances in medical treatments, and other areas, can also be expected to contribute to increased demands on public expenditure.

On an individual level work flexibility in older age has already emerged as an observable feature. Some chose to work post normal retirement age while others, as a result of inadequate (absolute or relative) retirement savings, find it necessary.

This is, as the Green Paper acknowledges, a complex area which will evolve over time. Some employments are not consistent with increased retirement age while others are. The focus of Government policy on the development of the knowledge based economy may contribute to, or be aided by, work flexibility in older age.

We have become accustomed to recognising 65 as 'normal retirement' age. For many reasons – historic, convention etc this has permeated much of our legislation and pension/retirement practice. As the Green Paper illustrates (particularly in Chapter 4) we must acknowledge that a future consequences of inadequate retirement provision will be longer periods of employment.

It is our view that flexibility must be introduced to facilitate and encourage people to work beyond normal retirement age. Within the Social Welfare system existing barriers should be removed and the option of deferral or partial drawdown of the Social Welfare pension introduced. Within the tax system both the age tax credit and the exemption limit (or variations thereof) offer opportunities to influence post normal retirement age work. The tailoring of PRSI exemption limits might also be relevant. We believe that removal of the existing requirement for certain members of Defined Contribution Schemes to purchase annuities would facilitate a phased move towards full retirement. IAIM does not believe that a prohibition on employers from setting prescribed retirement ages is feasible. The desirability or practicality of such limits, vary between companies and sectors. However, the amendment of some traditional linkages (such as to the Social Welfare pension) and more flexible conditions would support more options in retirement.

As the Green Paper acknowledges increasing the retirement age for Social Welfare pensions has one overriding benefit-cost saving. The disadvantages are more difficult to financially quantify, however, they are significant. As we have stressed earlier there is no simple approach to pension reform. To consider such a significant step without evidence that other potential elements of reform, particularly those aimed at earlier engagement in retirement saving, have failed would in our view be pre-emptive. If an increase in the retirement age is considered necessary in time, then it must be signalled well in advance of actual implementation.