Green Paper on Pensions

A Submission from Irish Life & Permanent plc

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Contents

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1) Executive Summary

Research from numerous sources has shown that over the next fifty years and beyond, Ireland's population will continue to grow older on average, with a resulting rapid reduction in the ratio of people working to people retired in the country, and a corresponding increase in the number of years people can expect to live.

While the progression of this ratio is affected by many factors, including the number of children born, the level and nature of immigration and trends in mortality, It is difficult to foresee any realistic scenario in which the number of workers per retired person would not fall rapidly over that period.

As has been widely documented, this relentless trend has important implications for retirement funding in Ireland, both public and private. All parties must act now to implement a pension system which can deliver successfully against this difficult demographic background, in a manner that spreads cost and risk between the various stakeholders in an equitable and viable manner.

The Government is often seen as the party most responsible for ensuring a secure retirement for Irish people. However, Irish Life would acknowledge that the pension issue is only one of many important economic considerations that the Government must manage. In this broader context, we believe the objective of the State pension system should be to provide a safety net against absolute poverty, and we suggest the level of pension proposed in the current Programme for Government represents an adequate pension in this context. Once this commitment is reached, future increases in State pension should be in line with increases in the level of average industrial earnings. We would support simplification, increased flexibility and broader access in the State pension system, but we would not support calls for substantial increases in the level of pensions beyond those currently planned.

We suggest that responsibility for funding pensions above this minimum level should rest with employers and workers themselves through private provision. Of course, the Government has an important role to play here too, since it is responsible for implementing a supportive policy and tax relief platform to create appropriate incentives for private pension saving.

The quality of pension provision in Ireland varies considerably between individuals and in particular between different groupings of employees.

Many employees are members of generous occupational pension schemes that will provide a comfortable level of income in retirement. Many of these employees also make effective use of AVC arrangements to further improve their retirement provision.

Other employees, however, are not so well prepared, and we believe these employees should be the focus for future occupational pensions reform. Some of these employees may be eligible to join their employer's pension scheme but have chosen not to do so – around two thirds of Irish DC schemes are set up on a voluntary membership basis. Other employers may not offer membership of a pension arrangement at all.

Similarly, pensions coverage across the self-employed sector is patchy.

A less visible, but nonetheless very serious, problem is the substantial numbers of workers who are saving for their retirement, but at a level unlikely to generate a large enough fund to provide sufficient income for a comfortable retirement – the adequacy issue.

In the view of Irish Life, the only effective way to tackle the pension coverage issues mentioned above is through an auto-enrolment system whereby employees must be automatically included in a suitable pension arrangement, with the right to withdraw should they choose to do so. The adequacy problem is best tackled through initiatives to improve member awareness, engagement and understanding so that they take responsibility for their own retirement planning to supplement a solid base of State and employer funding.

Moreover, we believe that demographic trends demand that, as a society, we must challenge our expectation of retirement at 65. This is an increasingly unrealistic target from a cost perspective, and is also questionable from the economic and social standpoints. We must give serious consideration to gradual extension of the retirement age beyond age 65, as well as to more creative alterations to facilitate those who wish to retire in a gradual or flexible manner.

We suggest that the private pensions saving element is best provided through the existing private sector infrastructure, using a PRSA vehicle or pre-existing occupational scheme where appropriate, supplementing pensions provided from State resources. The industry has proven itself capable of delivering efficient administration of pensions schemes at a reasonable cost. It would be a mistake to further complicate the pensions infrastructure by adding yet another approach to the already complex picture.

Employers should be asked to make a reasonable minimum contribution to the retirement pot of all employees who do not opt out of the pensions system. The choice of the level of contribution required from employers is a difficult one – if the level is too high, we risk hindering the competitiveness of Irish employers internationally. If the level is too low it is likely that the quality of resulting pension provision will be poor – furthermore, a ‘levelling-down’ process could drive down the quality of existing pension arrangements. We make a number of suggestions mitigating these risks later in this paper.

The success of the SSIA initiative is often cited as an argument in favour of the expression of pension tax reliefs in a similar manner to SSIA’s. In our view, however, the high take-up of SSIA’s resulted more from the ‘one year only’ nature of the offer than from the manner in which the tax advantages were communicated.

We do not believe it is necessary to make significant changes to the existing tax relief system as it applies to pensions. We demonstrate later in this paper that the existing system targets tax relief effectively towards middle income earners, rather than to higher income earners as it often stated. Altering the system will make pensions an even more complex proposition for workers.

It is certainly true that the high value of pension tax relief is not generally well understood by consumers. Public and private stakeholders have an important role to play in improving the quality of communication of the very high value of tax incentives to workers.

2) The Social Welfare Pension System

Irish Life's position on the State pension is that its key role should be to act as a safety net ensuring that no citizen is at risk of absolute poverty in retirement. Therefore we argue that the pension should be set at a monetary level that ensures affordability of a reasonable standard of living. Setting the level of State pension too high will create an expectation amongst workers that the Government is responsible for retirement provision. This is likely to lead to relentless upward pressure on the level of pension expected over time, with consequent negative impact on Government finances. In this sense, we believe that the choice of an appropriate level of State pension can play an important role in creating a culture whereby workers take responsibility for planning their own retirement funding above the level provided by Government.

Furthermore we believe that access to the State pension should be broadened to ensure that nobody slips through the cracks. In particular we would argue in favour of allowing discretion and flexibility where appropriate, including recognition of extra burdens in individual cases, e.g. caring for dependents.

We support the current government commitment to raise the State pension to €300 a week and suggest that this level of around 35-40% of GAIE seems appropriate in the context of the safety net role for the State pension.

We would encourage substantial simplification in the rules for eligibility to, and amount of, State pension:

- Current complexity leads to confusion and stress for people approaching retirement.
- Complexity also makes it difficult for people to plan properly for retirement.
- Tracking, retrieving and analysing past data over entire careers is a huge administrative burden for Government departments.

We believe the trends in population age structure and expected lifespan require us to give serious consideration to a substantial extension of the normal retirement age in the coming years. Maintenance of the retirement age at the current norm is neither affordable nor desirable from the societal and economic perspectives.

Furthermore, we would welcome the introduction of retirement age flexibility, including options to defer retirement, or to partially retire. These options would support a changed mindset where people take responsibility for planning their own retirement, in accordance with their preferred lifestyle, to supplement the coverage provided by Government.

This increased flexibility would also facilitate retention of the knowledge and experience of older citizens within the productive workforce, which would yield economic benefits for the country. We believe that partial retirement can also facilitate better quality of life, retaining purpose and motivation within people's lives, which has both societal and economic value.

3) Options Proposed For Improving Private Pensions Coverage

The level of private pension coverage has not changed significantly since the mid 1990's - despite increased publicity and education initiatives over this period it still falls well short of the National Pensions Policy Initiative target.

Many workers are eligible to join existing occupational pension schemes, but have chosen not to do so. Others do not have the opportunity to join an occupational scheme, and have chosen not to make their own pension arrangements. Many in the self-employed sector have similarly not made pension arrangements.

In our view, the system most likely to successfully resolve this coverage problem is a 'soft-mandatory' approach with employees automatically enrolled into a suitable pension scheme with agreed minimum levels of employer and employee contributions. In reaching this view, we considered a number of the alternative options outlined in the Green Paper on Pensions:

Enhanced Social Welfare System

One option to jointly resolve the pensions coverage and adequacy issues is to substantially enhance the Social Welfare pension. This approach might be seen as efficient from the administration perspective, since the revenue collection and pension payment infrastructure is already in place.

However, there is already a significant projected rise in the cost of the Social Welfare system as a consequence of change in demographics. In addition the Programme for Government has already made a commitment to increase the State pension to at least €300 per week by 2012. Enhancing the system on top of this will create substantial challenges. If this is to be funded through additional taxation it is likely to be an indiscriminate burden across the workforce

The benefits of an enhanced system would be spread across the community regardless of income levels and alternative sources of savings. Higher income earners would receive the same benefit as middle and lower income earners. Consequently enhancing the system does not necessarily direct the benefits to the people who need them most.

Overall, we feel an enhanced Social Welfare system will result in the costs and benefits of the system being spread in a manner which is neither fair nor equitable, nor conducive to the continued economic success of the country. Moreover, we argue that for any retirement savings system to be truly successful, it must have the effect of empowering and encouraging workers to engage fully with the challenge of planning for their own retirement.

Mandatory System

A second option is to introduce a mandatory system whereby all workers must contribute in a prescribed manner.

A mandatory system would clearly maximise coverage, by definition. However the mandatory approach fails to recognise that a supplementary pension is not appropriate for everyone. For example, the State pension may be viewed as a sufficient level of income in retirement by some, while others may feel they have sufficient non-pension wealth to provide for their needs in retirement.

The choice of the levels of required employer and employee contributions under a mandatory system is a very difficult policy challenge. If these are pitched at high levels, the mandatory pension system might be perceived as a punitive additional tax, damaging Ireland's reputation amongst existing and potential employers.

Pitching the mandatory contribution levels too low presents an even more insidious danger – that the level required becomes established as the default contribution level across all schemes, leading to inadequate retirement saving by future generations of Irish workers under the mistaken illusion that they are members of a quality pension plan. Furthermore, the quality of existing pension plans might well be damaged as the establishment of a low default contribution level creates an incentive to level these schemes down.

Finally, the mandatory approach is not conducive to development of an environment whereby individual workers each engage with the retirement planning challenge - a recipe for mediocre pension provision for future generations.

4) Soft Mandatory System - Features

Soft Mandatory System

Irish Life believes that the objective of increasing pension coverage is best achieved by supplementing the existing social welfare system with a soft mandatory system where all workers are automatically enrolled into a pension scheme, with limited freedom to opt out.

The existing voluntary supplementary system has not succeeded in improving coverage or adequacy to any great degree. Some of the key reasons for this include:

- pensions are not seen as a priority for younger workers
- there is insufficient knowledge and understanding of the level of savings required to fund an adequate retirement income
- the tax benefits are not widely appreciated
- saving for retirement locks up assets for a long time

Irish Life has been running campaigns with supportive employers over recent years to boost coverage and adequacy in their pension schemes. The great majority of employees we meet understand that they should save for their retirement, and that the sooner they start the better. However, many of them fail to make the decisions required to put suitable arrangements in place

When faced with a complex or difficult decision individuals often employ two simple rules of thumb “keep things as they are” (inertia) and “put the decision off until tomorrow” (procrastination) – even when they intuitively know that they would be better off to make and implement the decision.

Even when individuals acknowledge or understand the need to make a behavioural change, inertia and procrastination frequently prevent them taking action. The problem is not one of awareness. Rather the problem is how to get individuals who are clearly aware of an issue to take specific action.

Substantial investment by both public and private bodies in recent years has been very successful in increasing pensions awareness amongst Irish workers, and it is crucial that all parties remain committed to continuation of this awareness programme. However, increased awareness has not led to a notable increase in the proportion of workers making positive pensions decisions. Most workers are aware of the importance of pensions; what is needed is a more effective stimulus for taking action, taking natural human tendencies towards inertia and procrastination into account.

Research (see Appendix 1) has shown that this inertia can be turned on its head so that it becomes a positive force for pensions coverage and quality improvement. If workers are automatically enrolled into a pension scheme that they intuitively know to be a good thing for them in the long term, we would expect to see very few of these workers then choosing to leave the scheme. Leaving the scheme, not joining, now becomes the big decision. While some workers will opt out for perfectly rational reasons, most will realise leaving is not a sensible decision, and therefore natural inertia will drive most workers to remain in the scheme.

Scope

Irish Life would support the introduction of automatic enrolment for all workers regardless of income level or age. The automatic enrolment system would allow people to opt out of the pension plan thereby providing an effective solution to the problems of inertia outlined above while still giving people a real choice as to whether they wish to participate or not.

Self-employed workers should be included in the same system as all others.

All workers, regardless of income level, should have the best opportunity to fund for benefits over and above the State Pension, to have access to the Tax Free Lump Sum benefit at retirement and enjoy the tax benefits associated with supplementary funding. Limiting access by means of age limit or income threshold would deny this opportunity as well as being problematic to administer.

Contribution Levels

As noted earlier in this paper, choosing the appropriate minimum levels of employer and employee contribution under the proposed 'soft-mandatory' system is difficult – low contributions threaten pension adequacy, high contributions threaten employer competitiveness.

We propose that an initial level of required employer and employee contribution of 2% of annual earnings each be mandated under this system. We propose that these contribution levels should increase to at least 5% each by 2015, with the pace of such increase being an item for agreement under partnership.

In this way, the key employer component of retirement saving would be introduced at a level that is acceptable from the competitiveness perspective, with a mechanism for introduction of increased levels of contribution over time in tandem with other negotiated initiatives under partnership.

Data presented in Table 9.2 of the Green Paper suggest that the 5%/5% minimum level proposed here represents a reasonable level of minimum contribution for young employees on low to middle income levels who will continue to save throughout their lifetime, targeting a reasonable level of pension taking the State pension into account.

Workers on higher income levels, and those who hope for a higher replacement income ratio in retirement, must be encouraged to take responsibility for funding at a higher level than the suggested minimum. Similarly, the minimum level proposed here is not sufficient to provide for a decent level of pension for older workers with insufficient provision already in place.

It is clear that the pensions burden is lightened considerably when pension saving starts at a younger age. The auto-enrolment system we have proposed represents the best opportunity to transform our experience in this regard, by ensuring that the great majority of workers will begin saving for retirement, at least at a minimum level, from early in their working lives, thereby sparing themselves the pain of much higher contribution levels required later in life.

A clear communication approach is required to ensure that all workers can be put in possession of the realistic situation regarding their retirement income prospects, and the changes they must implement to target their desired retirement income level. As described elsewhere in this paper, Irish Life has had considerable success in communicating these messages effectively to employees through engagement in the workplace.

Pensions - An Attractive Element of the Benefits Package

We suggest that an increase in the profile of pensions as an important component of an employee's benefit package would be a healthy development. To this end we would propose the introduction of an official rating system whereby the quality of the pension contribution levels offered by employers can be easily compared, for example:

Class A	9% or more of annual earnings
Class B	6-9% of annual earnings
Class C	4-6% of annual earnings
Class D	2-4% of annual earnings

Introduction of such a system would have two main advantages:

1. Encourage competition on the level of pension contribution between employers seeking to hire or retain staff.
2. Allow the level of pension contribution to vary across employers and industries according to local conditions, without an overall levelling-down effect across all employment.

Finally, our experience has shown that setting clear expectations for employees and trustees on the level of funding required to target specific levels of retirement income is crucial to successful retirement planning. Therefore we suggest that the soft-mandatory system should incorporate a mandatory requirement to offer group and one-to-one information on appropriate funding levels to all stakeholders.

5) Soft Mandatory System – Further Comments

PRSA Basis

The existing private sector infrastructure has proved to be successful in efficiently administering and managing pension plans. This infrastructure, combined with pensions legislation and regulation, represents a secure and proven foundation for developing a sustainable system to ensure increased coverage and adequacy of retirement income in a secure, regulated environment.

Existing arrangements can be altered or extended to comply with the auto-enrolment system where appropriate, and this may well be the preferable course in many cases.

Where new arrangements are to be set up under the auto-enrolment system we have proposed, we suggest that these should use the existing PRSA pension plan vehicle as their basis. The standard PRSA provides an uncomplicated, low cost and portable model for pensions saving. It is already well regulated and is a solid alternative to trust based schemes.

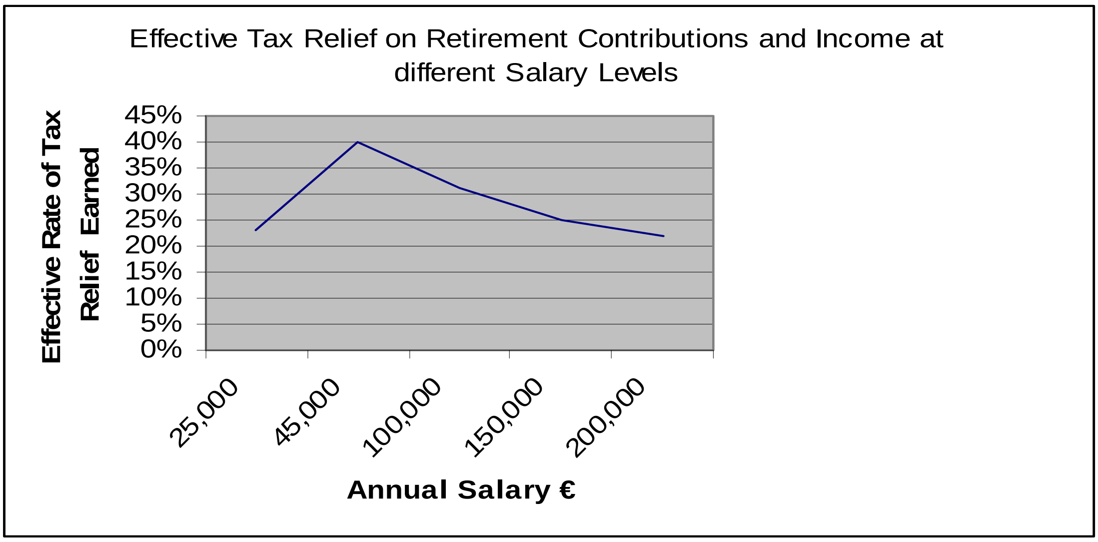
The costs associated with group PRSA contracts compare very well with other pension savings vehicles both in Ireland and abroad. Moreover, competition between PRSA providers has already driven the typical charges seen in the market below the capped charges stipulated in regulations. We would expect this trend to continue as pension savings volumes increase rapidly under an auto-enrolment system.

One drawback is that the current PRSA regulations seem inequitable in the treatment of employer contributions when compared with the personal/occupational pensions tax treatment. We suggest that this anomaly should be removed in order that PRSA savers enjoy the same benefits as other pension savers.

Taxation

Contrary to popular perception, we believe the current system of taxation is effective in directing the highest levels of tax relief on pension contributions to employees on average incomes saving a moderate amount for retirement. This effectiveness is illustrated by the graph below.

Therefore we suggest that no changes to the existing system of tax relief on pension contributions is required, although we note that all stakeholders must work harder to ensure the value of these reliefs is more effectively communicated.



The graph above shows how the current taxation system affects an individual saving 20% of salary per annum at a number of different levels of annual salary. The level of tax relief earned falls off at higher salary levels as higher earners tend to pay more tax on their pensions in retirement. The current system of taxation gives most relief to taxpayers with salaries just in excess of the marginal tax band who are saving a moderate amount for retirement. Costly new tax incentives are therefore not necessary and may have unknown repercussions in terms of the distortions they would cause in a system which already works effectively. Further details on the above graph are available in Appendix 2 to this report.

Access to Funds Before Retirement

Pensions can seem quite unattractive from the perspective of younger workers, for a number of understandable reasons:

- Retirement is a long way away for younger workers
- Many younger people have more immediate priorities such as travel, education and home ownership. These competing demands inevitably push pensions down the agenda.
- The value of tax relief is offset by the very long time period during which funds are inaccessible.

This lack of appeal for pensions amongst younger people is unfortunate – the earlier workers begin saving for retirement, at whatever level, the more likely they are to achieve their retirement income goals without major sacrifice.

For this reason we would strongly support initiatives to grant limited access to accumulated pensions savings for younger pension savers – this would allow younger workers to begin saving for retirement without fearing that they have no recourse to these funds for many decades.

Any such system would by necessity impose strict controls on the circumstances in which funds may be accessed. Some suitable conditions might include:

- Access only up to age 40
- Access only on the occurrence of specific events – e.g. house purchase
- A maximum of 50% of the fund available

We note that the 'Kiwi Saver' soft-mandatory system introduced in New Zealand has incorporated this feature.

Extension of ARF Retirement Option

We propose that access to the ARF retirement route be made available to all members of Defined Contribution arrangements. The defined contribution nature of the ARF is an excellent complement to the format of the original defined contribution arrangement. Removal of the compulsory purchase of an annuity would remove the artificial curtailment of the investment time-horizons of members of defined contribution schemes. Defined Contribution scheme members will still have the option to purchase an annuity, should they wish to do so.

Experience with ARFs to date suggests that people are unlikely to fall into the trap of exhausting their ARF before they die. Indeed experience has shown the converse to be true with people being more likely to draw down ARF funds at a very slow rate. The potential deferral of income drawdown resulting from use of ARFs has implications for the pattern of tax receipts available to the Revenue Commissioners. The current imputed drawdown system should form the basis for future measures taken to ensure that the Revenue's pattern of tax receipts is not excessively disrupted by the widespread availability of ARFs.

We would not support the extension of ARF flexibility to Defined Benefit schemes. The nature of the defined benefit promise would be fundamentally altered should such a change be introduced, and we believe that this would not be in the interests of the large number of employees still covered in defined benefit arrangements. In opting for an ARF they would forego valuable security in their existing defined benefit arrangement.

6) Soft Mandatory – Potential Challenges

Automatic Enrolment and Adequacy

One potential challenge with the automatic enrolment approach is that employee contribution rates could remain at a level that is too low to generate adequate retirement savings. Employees who are automatically enrolled in their employer's pension scheme usually choose the default contribution rate which is generally too low to provide an adequate retirement income over the long term.

In our experience the most effective approach to tackling this issue is focussed member education, and we suggest that a requirement for group and individual member education be built into the soft-mandatory framework.

Existing Occupational Pension Schemes

Another potential challenge is that a soft mandatory system could drive savers in good occupational schemes into a lower savings regime overall. Existing members of pension schemes may opt to reduce their savings levels to the minimum level allowed under the soft mandatory system.

We believe that the system should protect against the chance of this occurring. Transfers of preserved benefits from an occupational scheme to a PRSA prohibit an employee who has more than 15 years scheme service with the employer from doing so. Likewise the new system could prohibit existing members of occupational schemes from changing their contribution terms below the existing scheme minimum level once they have 15 years service with the employer.

We recommend that rules concerning transfers from a Defined Benefit scheme to an auto-enrolment scheme are the same as those in place for PRSAs at present (as above). Certain disclosure requirements should apply. In addition, a provider of an auto enrolment scheme should not be able to accept a transfer of funds from a Defined Benefit scheme unless the transferring member has been given a certificate setting out a comparison of the benefits which may accrue from the Defined Benefit scheme and the Auto-Enrolled Scheme, and a written statement as to why a transfer is or is not in the interests of the scheme member making the transfer.

Employer Attitude

An auto enrolment system would potentially be open to abuse by employers in that they could encourage employees to opt out.

We recommend that members be allowed to opt out of the arrangement after a minimum period of six months' membership. This time period will serve as a robust barrier to unscrupulous employers trying to encourage their employees to opt out of the scheme at an early stage. By the six month stage the savings habit will be ingrained for many and unscrupulous employers would face opposition from employees if they tried to encourage employees to opt out.

Tighter rules may be required in the event that many workers choose to opt out over time, however we believe this is unlikely to occur.

7) Challenges Facing a Centralised State Run System

As outlined elsewhere in this paper, we believe the existing private sector DC premium collection/investment infrastructure offers an efficient and effective vehicle upon which to base the proposed soft-mandatory system.

One alternative is to create a public State-run infrastructure, however we believe this entails a number of drawbacks.

Investment Solutions

Historically it has been shown that higher levels of investment return can be achieved by choosing investment funds which have a well balanced risk profile. The private sector has considerable experience in constructing investment portfolios which can provide a higher long term return through sensible management of investment risk. This is an appropriate strategy when managing funds that are supplementary to the main Social Welfare pension.

A state run scheme might not be afforded the political freedom to pursue such a long term strategy with individual citizens' retirement accounts. It is likely that public reaction to short term investment fluctuations would be negative and it is likely that many would expect the state to provide guarantees which would rule out the possibility of taking on appropriate levels of investment risk. Over the long term this will result in lower returns and increased pensions cost.

In our view, it would make little sense for the State to become involved in this issue.

The private sector has experience in developing and explaining suitable long term investment strategies which facilitate better returns for an appropriate level of risk, and is therefore well-positioned to provide the most appropriate investment solutions required for retirement saving.

Adequacy

One of the key objectives of the pension system is to ensure that members achieve an adequate replacement income in retirement. This requires a resource-intensive education and sales process.

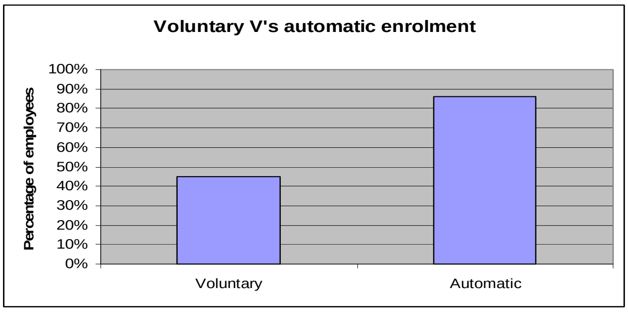
As already outlined one of the risks attaching to an auto enrolment or mandatory pensions system is that members will just adopt the minimum default contribution rate which will not usually sufficient to provide an adequate pension. This can be tackled by putting resources in place to review individuals' level of retirement saving on a regular basis. Private sector pension providers are well positioned to do this with members to facilitate them increasing their pension savings in order to ensure an adequate level of retirement income. Irish Life's experience in this area has shown success in raising contribution rates after conducting employee presentations.
A state run system is unlikely to be in a position to commit the same level of resources to improve savings adequacy and consequently is likely to result in an overall lower level of resulting retirement incomes.

8) Appendix 1

Vanguard Study – Measuring the Effectiveness of Automatic Enrolment

A U.S. study published in December 2007 by the Vanguard Centre for Retirement Research showed that the effects of automatically enrolling employees in a pension scheme boosted the participation rates from 37% to 86%. By comparison, only 45% of employees hired under voluntary enrolment join their pension plan, with 55% failing to join.

For employees hired between January 1, 2004, and September 30, 2006, as of December 31, 2006



In this particular study automatic enrolment appears to raise plan participation rates most dramatically among certain demographic groups, particularly young and low income workers. For example, employees earning less than $30k and hired under automatic enrolment have a participation rate of 77% versus a participation rate of 25% for employees at the same income level hired under voluntary enrolment. Similarly, 81% of employees younger than 25 are plan participants under automatic enrolment versus 30% under voluntary enrolment.

Although the effects are strongest for these demographic groups, even the affluent benefit from automatic enrolment. Among these earning more than $100k a year, new hire participation rates are 20% higher under automatic enrolment than voluntary enrolment.

Appendix 2

Calculations in Relation to the Effectiveness of the Current Taxation System

The main assumptions underlying this model are as follows:

- The figures are based on a 40 year old male who saves 20% p.a. to age 65.
- He is assumed to take a tax-free lump sum of 1.5 times salary and to purchase an annuity with the balance.
- He is assumed to live until age 85.
- It is assumed that current tax bands, limits etc increase with wage inflation.

This analysis takes into account the future tax that will be paid by pensioners in retirement. The model discounts the pension contributions, the tax relief on these pension contributions and the additional tax he pays in retirement on his additional pension. A single effective rate of tax relief was then calculated by dividing the present value of the net tax relief received by the present value of the contributions paid.