Pensions in Ireland: Addressing the Challenges

Society of Actuaries in Ireland
Evening Meeting, 2nd April 2008

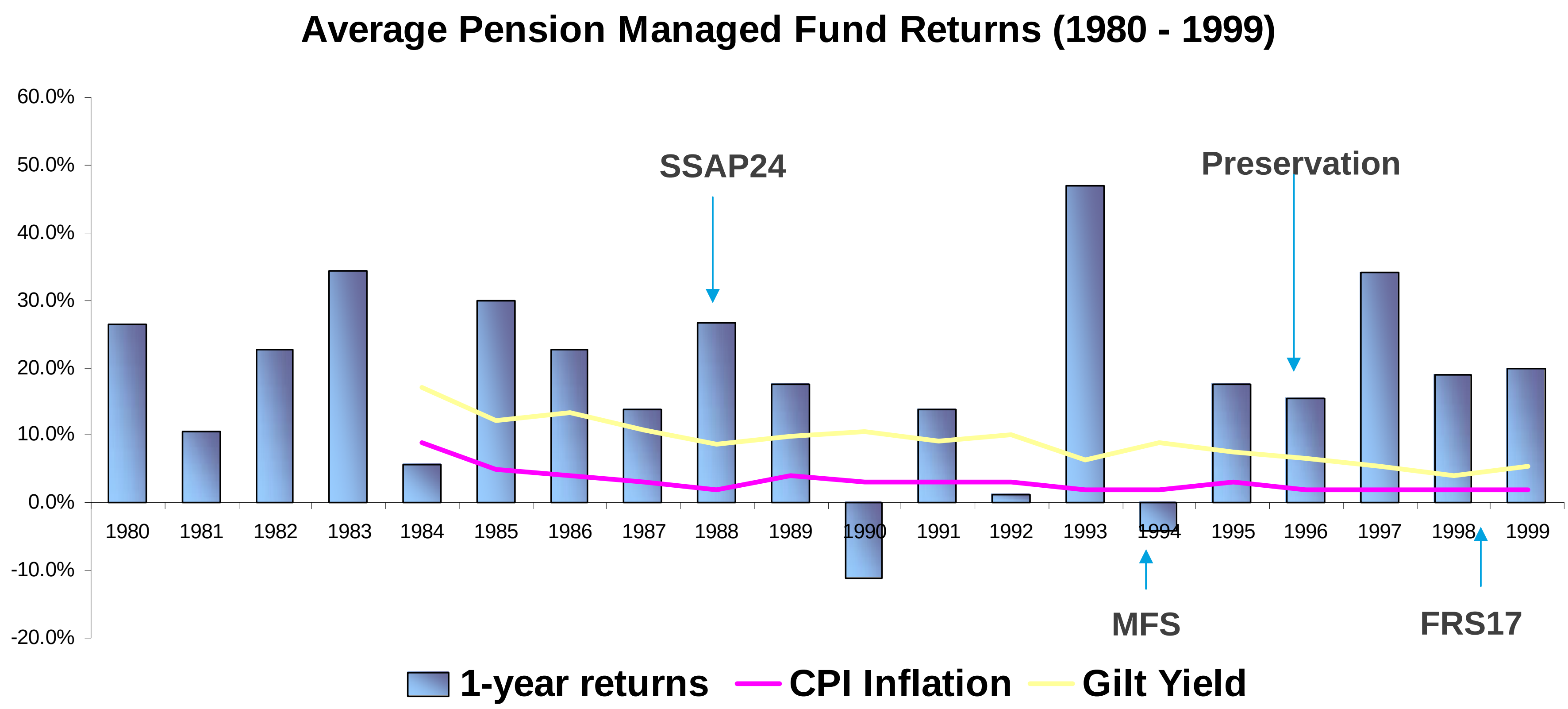
Private occupational pensions:

challenges facing the existing model

Roz Briggs

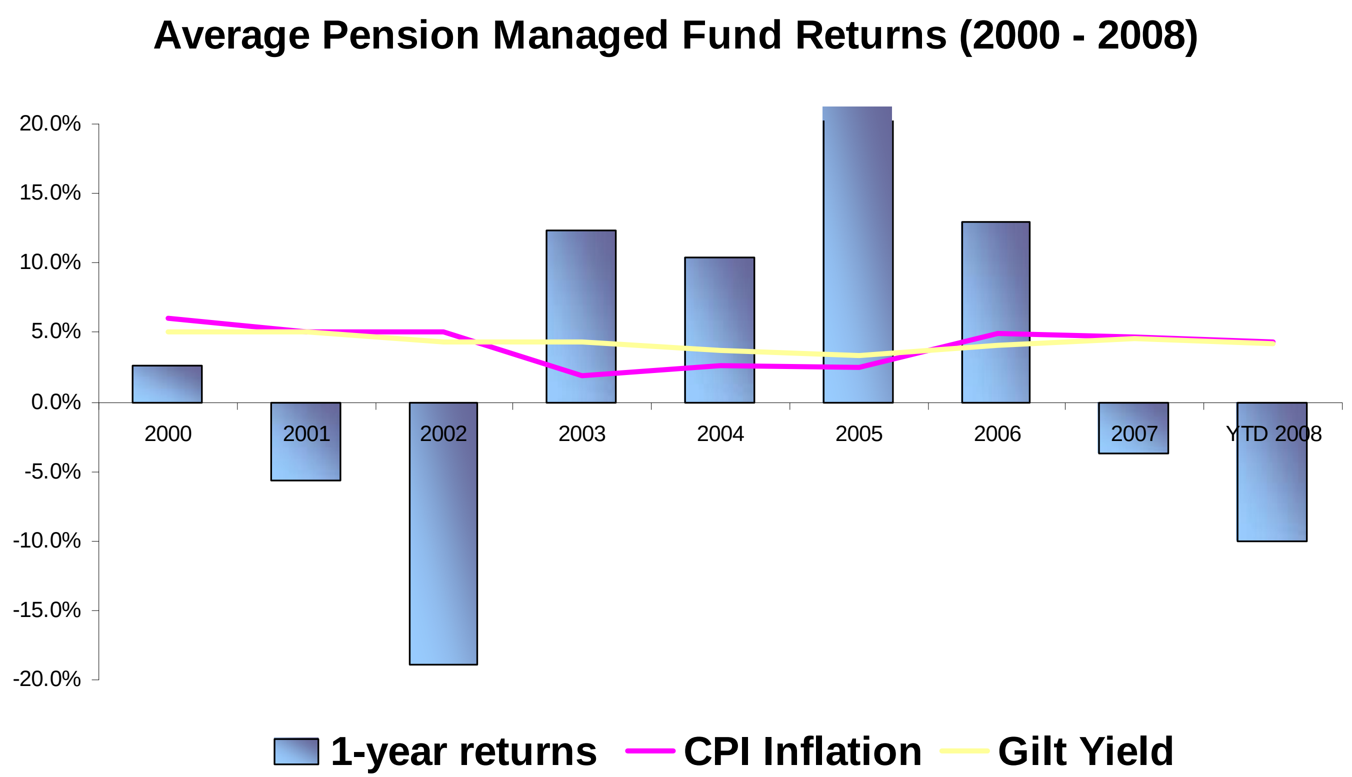
The way it was……

Asset performance 1980-1999



Since then……

… and 2000-08

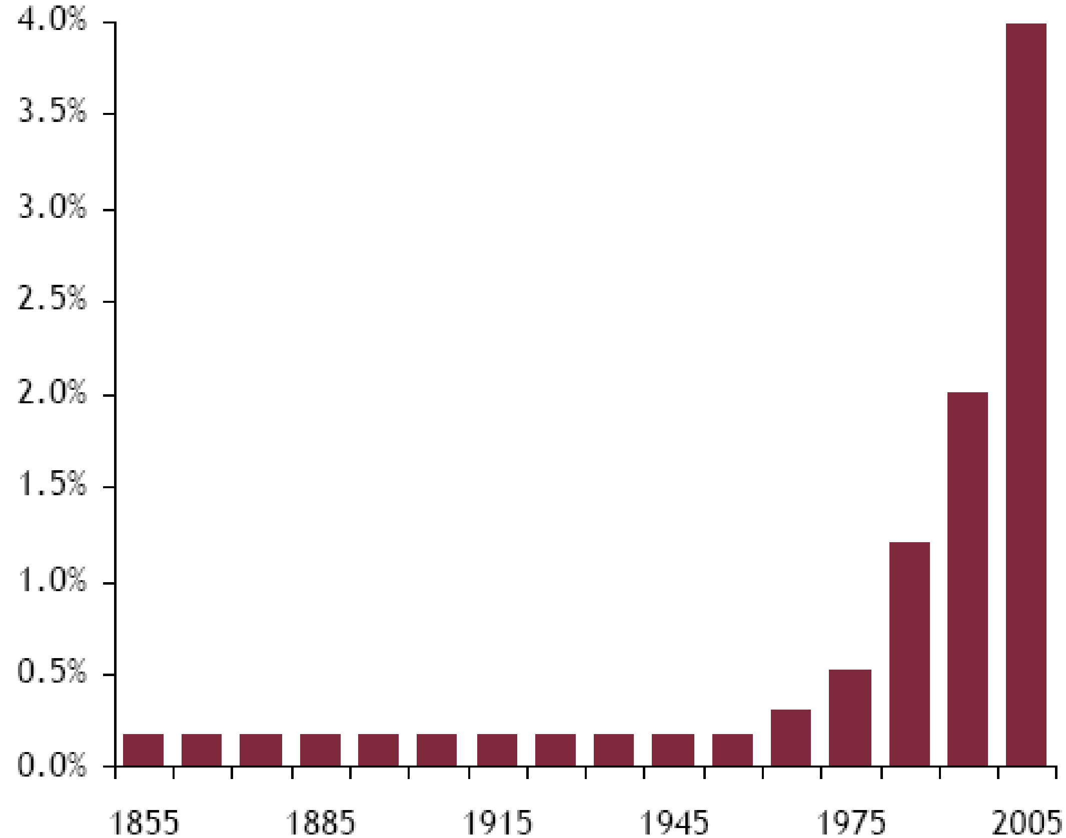


Managed Fund returns for the year to date 2008 are provisional to the 31st March 2008

Ever-increasing life expectancy

We are seeing unprecedented change

Average annual reduction in mortality rates for men in England & Wales aged 65-74 (smoothed)



Source: Mr. Richard Willets presentation to SAI 13/6/2007

Ever-increasing life expectancy

- 2007 SofA pensioner mortality survey suggests current mortality rates close to PMA 92 medium cohort
- Medium cohort involves increase in life expectancy to 23 years for 40 year old male (19 years under TV basis)
- ….and remember PA(90) was 14.6 years!
- ….I scared the Pension Partnership group in 2006 by suggesting that 20 years was closer to the mark
- ….and medium cohort approach may not be enough

The march of consumer protection……

Way back when…	*Now*	*Coming?*
➢Focus on retirement	➢Index-linked preservation	
➢No early leaver rights		
➢“Long-term” funding approach	➢Market related assumptions	
➢Limited disclosure of information	➢Comprehensive – including preserved rights	
➢Little focus on wind-up funding	➢MFS	➢Solvency II
➢Limited member participation in trusteeship	➢Member selected trustees	
➢No protection on wind-up in insolvency	➢Ditto - appreciated by members - less secure for <65’s	➢Debt on employer? ➢ pension protection fund?

The march of financial reporting……

Way back when…	*Now*	*Coming?*
➢Report cash cost	➢Rule based	
➢Discretionary methodology	➢Prescribed	➢Economic valuation of liabilities
➢Typically long-term assumptions	➢Market related	
➢No balance sheet entry	➢Full recognition of surplus/deficit	
➢No transparency	➢Much more transparency	
➢No risk assessment	➢Encourages equity investment without measuring risk	➢No advance credit for unearned equity return
➢Going concern measurement	➢Ditto	➢Current salary approach
➢Stable cost	➢Volatile balance sheet and P&L	

Reality in Ireland

	Defined Benefit Schemes*		Defined Contribution Schemes	
No. Of	Schemes	Members	Schemes	Members
1995	2,067	203,146	42,565	78,974
2005	1,305	239,127	82,841	234,814
% change	- 37%	+18%	+95%	+197%

*Subject to the funding standard

Available from Pensions Board Annual Reports

Studebaker

- The company laid off about 5000 workers and terminated the pension plan, which had been negotiated with the United Auto Workers Union
- Plan created in 1950
- Granted prior service benefits, so there was an immediate unfunded vested liability of $18m, which was amortised over 30 years
- Benefits improved in 1953, 1955, 1959, and 1961, each time creating past service credits the costs of which in every case were amortised over 30 years

Source: Imperial College London & Tanaka Business School

Studebaker pension plan

- There was $24m in the pension plan when it was terminated
- In terms of the termination, workers divided into three groups
  - 3,600 retireds and actives over the age of 59
  - 4,000 members with vested benefits (over the age of 40, > 10 years service) [average age 52, 23 years service]
  - 2,900 others
- Priority order was implemented, so the assets in the plan were first used to pay the first group, then the second, and finally the third
- First group took $21.5m, the second $1.5m (~15% of liabilities) and the third got nothing

Source: Imperial College London & Tanaka Business School

Studebaker plan termination

…. was completely legal, and gave rise to no litigation, ….

- **…. but caused such a furore that in 1974 the US Congress passed the Employee Retirement Income Security Act (ERISA), which:**
  - **created a legislative framework for occupational pensions in the US and**
  - **created the Pension Benefit Guaranty Corporation, which was mandated to insure the DB pension liabilities of US companies**

Source: Imperial College London & Tanaka Business School

KEY QUESTIONS

How should all stakeholders manage increased life expectancy?

Can private sector DB survive consumer protection and reporting challenges?

Is there a need for DB?

What is the State's role?

Are we ok with one of the weakest pension protection systems in EU?

If we have concerns, how can we engage stakeholders?

How might the issues be addressed in a sustainable manner?

How best to manage DC plans?

Reform options in relation to

Social Welfare pensions

Aisling Kennedy

Is sustainability an issue?

- EU Review classifies Ireland as *medium risk* in terms of the sustainability of social insurance expenditure in the face of an ageing population
- This primarily reflects the high projected rate of increase in spending (albeit from a low base and strong budgetary position)
- 2007 Actuarial Review central projection estimates:
  - expenditure in real terms increasing by 945% between 2006 – and 2061
  - contributions in real terms (at current rates) increasing by 365% over the same period
  - gap between benefits and contributions equivalent to 6.4% of GNP

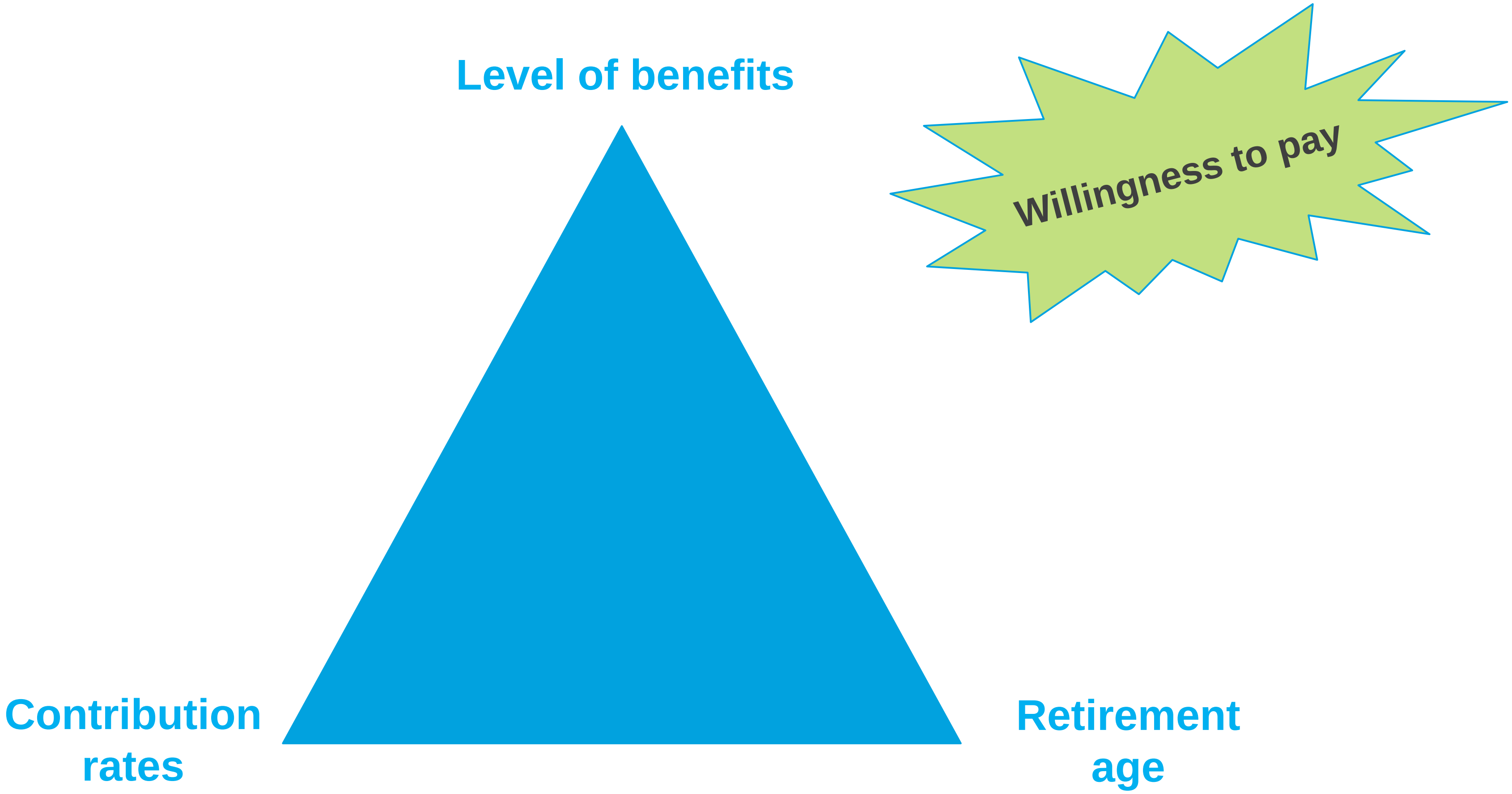
Social insurance contribution rates

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

Ireland – projected social insurance costs

- Green paper focuses on projected deficit if current benefits and contribution rates maintained
- Society response should emphasise the need to tailor contribution rates to expected costs
- Actuarial review of social insurance fund (2007) calculated "equalised" contribution rate for 2008 – 2061 as 174% of current contributions i.e. 22% - 26%
- This is well within range of current spend in other EU countries (current spend is projected to increase throughout the EU)
- "Equalised" contribution rates allowing for increase in State pension to 50% of GAIE in tandem with gradually increasing retirement age (to 70 by 2050) are 201% of current rates
  – also potentially affordable depending on societal priorities?

Sustainability



Level of benefits

- Society is on record as of the view that if any further mandatory provision is considered necessary this should be achieved by raising the State pension (rather than mandatory or "soft mandatory" DC top-up)
- Pros:
  - Administratively simple and cost-effective
  - DB (most suitable for lower – paid workers)
  - Redistributive
  - Benefits those already retired or close to retirement as well as younger workers
- Cons
  - PAYG (even if pre-funded, benefits are within political gift)
  - DB (rigidity re retirement age)

Retirement age

- Life expectancy – increases of approximately 1 year per decade achieved in recent decades and projected forward over the next 50 years

Projected "cohort" life expectancy at age 65

	Men	Women
2006[1]	21	23
2006[2]	21	23
2020[2]	22	25
2030[2]	23	25
2040[2]	24	26
2050[2]	25	27

[1](Shane Whelan projection presented to SSISI 01/08)

[2]UK GAD projections

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

Projected “cohort” life expectancy at age 65 – high life expectancy variant

	Men	Women
2006[1]	21	23
2006[2]	22	24
2020[2]	25	27
2030[2]	27	28
2040[2]	29	30
2050[2]	31	33

[1](Shane Whelan projection pres

[2]UK GAD projectio

Health warning!

These are figures for the general population. Pension scheme members have higher life expectancy.

***“Cohort** life expectanc … mortality rates which allow for known or proj … in later years and are thus regarded as a more appr … of how long a person of a given age would be expected to live, on av … than period life expectancy.”* [UK GAD]

Retirement age

- Life expectancy – increases of approximately 1 year per decade achieved in recent decades and projected forward over the next 50 years
- Evidence limited to date but extra years are largely healthy years i.e. onset of significant disability is postponed
- Potentially enormous future gains not built into current projections (projections have consistently substantially under-predicted improvements)
- Significant forward planning essential (minimum of say 15 – 20 years' notice of applicable retirement age probably appropriate)
- Should today's primary school children expect to retire at the same age as their grandparents?
- Potential trade-off between enhanced State benefits and later State pension age

Retirement age - what are others doing?

- Denmark will increase the normal retirement age for men and women from 65 to 67 between 2024 and 2027
- Germany is increasing the normal retirement age for men and women from 65 to 67 between 2012 and 2029.
- In Hungary, the intention is to increase the retirement age from 61/62 to 64 for women and from 62 to 65 for men by 2020 and then to 68 for women and to 69 for men by 2050.
- In the United Kingdom, a common State Pension Age of 65 will be fully implemented before 2020. This will be gradually increased between 2024 and 2046 to 68 for men and women.

Retirement age

- Early retirement option (from age 65, on reduced benefits) would help ease transition to a higher normal pension age - and offer choice (more viable if wider gap between means-tested and contributory benefits)
- Move to a “total contributions” basis rather than “average contribution” basis (as at present) would help to minimise inequity for lower socio-economic groups (who are likely to join work force earlier)

Current social insurance system

- **Current "average contributions" basis opaque and inequitable; inappropriate in a mature system**
- **"Total contributions" test preferable, and would help facilitate increase in retirement age**
- **Across EU, aggregate years' contributions in the range 35 – 45 years required for full benefits**
- **If total contributions system introduced, credits rather than "disregards" probably more appropriate for homemakers, carers etc.**
- **Long lead in would help with logistical issues e.g. introduction after 2019 would largely eliminate issues relating to pre-1979 records**
- **Individuals with contribution gaps could be allowed to make voluntary additional contributions to achieve maximum contributory State pension**

Current social insurance system

- Reform of current system for State Transition pension (between 65 and 66) is essential in order to facilitate phased retirement / encourage voluntary late retirement

Sustainability

- EU focuses on three-pronged approach:
  – Sound budgetary positions
  – Reforming pensions, health care and long term care systems to ensure financial viability
  – *Raising employment rates, especially among older workers*
- Pensions strategy is about more than pensions
  – Repositioning older workers within the workforce requires a dedicated initiative of its own e.g.
    - education
    - retraining schemes
    - employer incentives

Addressing the challenges :

options for defined benefit schemes

John Byrne

Need for DB

- ➢ Sharing of Investment and Longevity risk
- ➢ Provides a retirement income
- ➢ Society need for sustainable private sector pension provision
- ➢ Deferred Taxation and pre-funding
- ➢ Public sector is providing DB pensions

- ➢ **State could encourage DB provision by:**

- Tax incentives
- Appropriate levels of regulation
- Retirement Flexibility
- Informed communication with Social Partners

DB Protection Issues

- Perceived Security Levels that do not always exist for different categories of member
- Inequity between different member categories
- Geared pension investment for younger members
- No state protection of any kind
- Communication of Risks issue

Sustainable Approach

- Promise Less and Fund more securely
- Reduce Benefit Promise
  - Pension Increases
  - Pre-retirement revaluation
  - Increase Retirement Age
  - Final Salary / Career Average
  - Accrual Rates
- Legislation Changes
  - Priority order
  - Flexibility regarding accrued rights
  - Pension Protection Fund
  - State-backed annuity fund
  - Index-linked Bonds

Addressing the challenges :

Options for
Defined Contribution Schemes

Michael Bryson

DC Schemes – The Challenges

- Adequacy of Contribution Levels
- Communication of the Risks
- Increasing Coverage
- Facilitating Flexible Retirement

DB Scheme Recommended Future Service Contribution Rates

Typical 1990 (model 60ths scheme)			
	Age 35	Age 45	Age 55
No Pension Indexation	8.4%	10.1%	12.1%
CPI linked Pension Increases	12.2%	14.7%	17.7%

Typical 2006			
	Age 35	Age 45	Age 55
No Pension Indexation	11.2%	14.6%	19.0%
CPI linked Pension Increases	14.3%	18.6%	24.2%

Source : 2007 Green Paper on Pensions

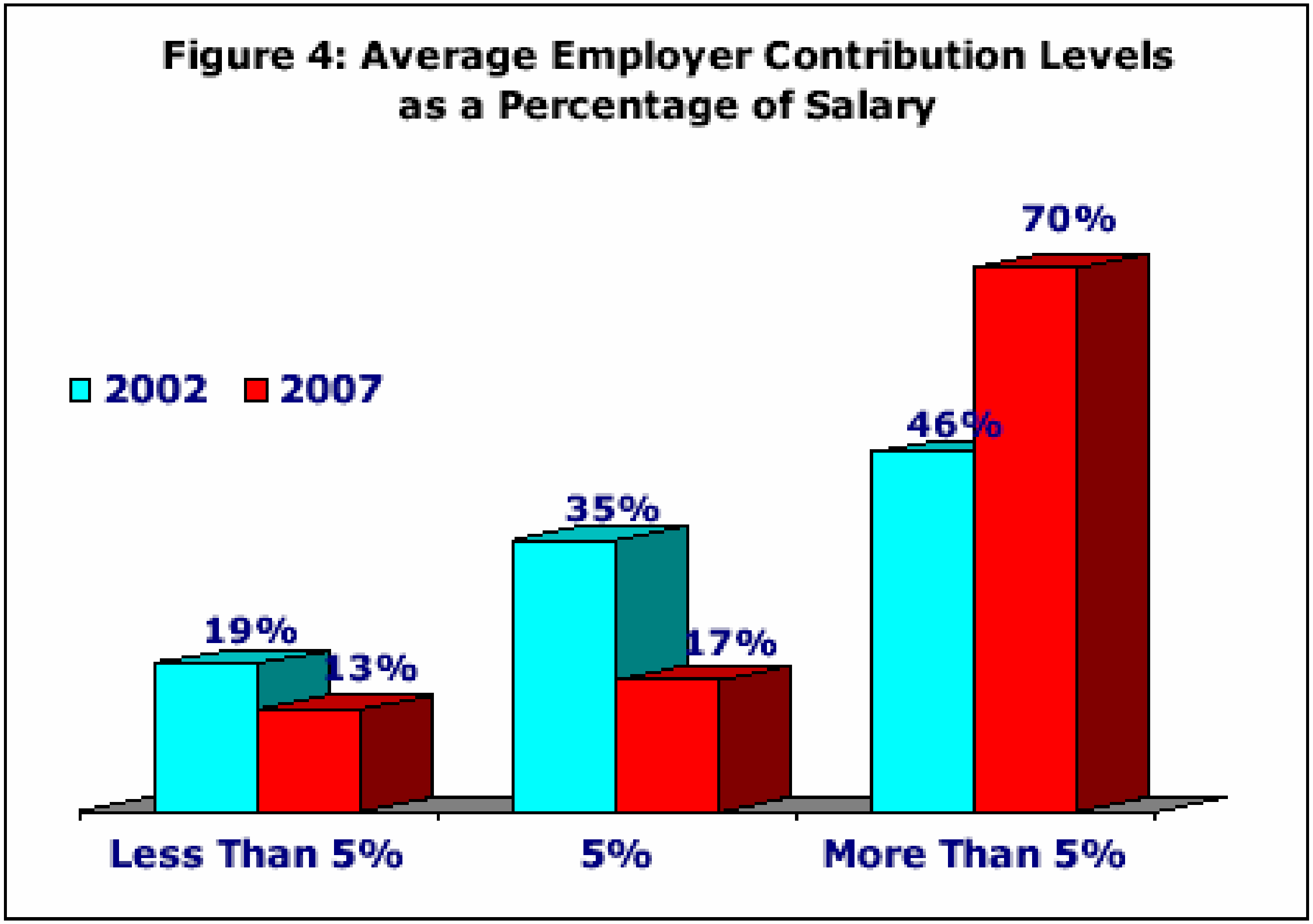
DC Scheme Required Future Service Contribution Rates

are affected equally by ….

- Increased Expected Longevity

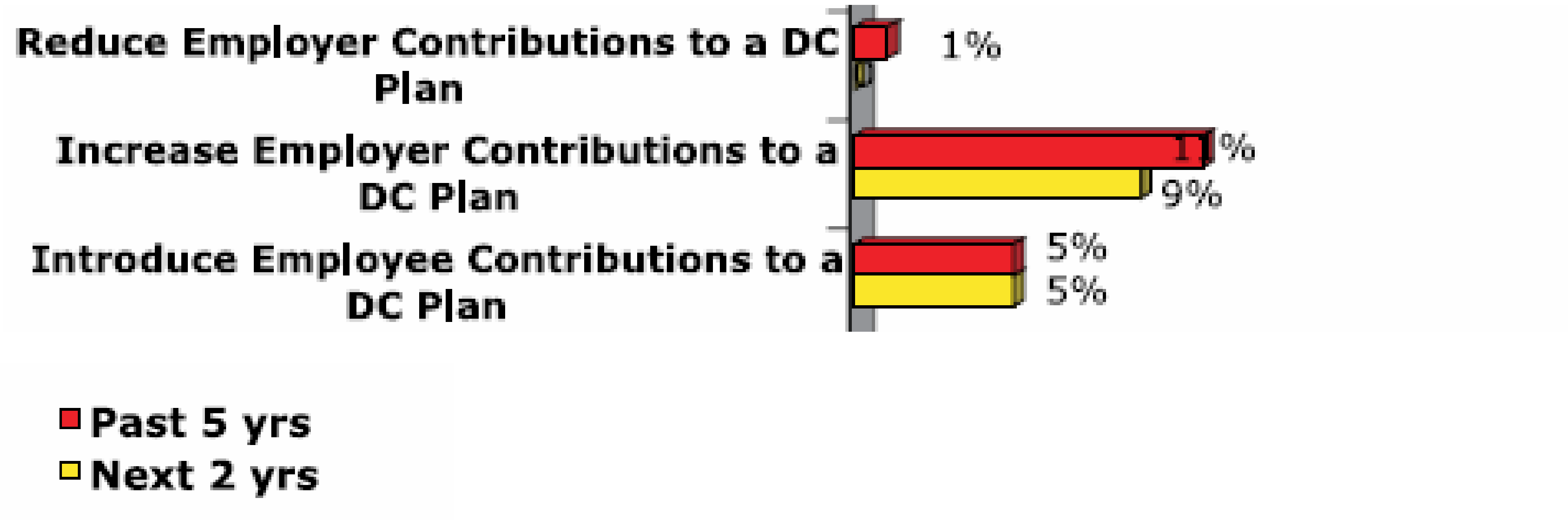
- Lower Anticipated Investment Returns

There is Some Evidence that Large Employers are Improving on the 5% + 5% Typical DC Offering



Source: IAPF Pension Market Survey 2007

Employer Trends & Plans for DC Pension Plans



… but In most DC Plans the Impact is Reduction in the Future Service Benefits – Shortfall to be met from AVCs?

Source: IAPF Pension Market Survey 2007

Communicating the Risk to the Individual

- **Expected Outcome of Little Relevance to Individual Member**
- **No Pooling of Investment or Salary Risk**
- **Individual must monitor own Fund and Target Retirement Income**
- **Investment Risk means adjusting contributions/expectations in light of experience**

Increasing Coverage – Lessons From SSIAs

- **Easily Understood Incentives**

- **Importance of Having Some Access to Funds**

- **Manufacture a Deadline**

- **"IAPF research found that 86% of those with no pension would start one under an SSIA type structure whereas 60% of those surveyed have little or no knowledge of how current tax incentives work."** IAPF Press Release March 2008

National Savings Scheme – Straw Man

- €1,000 initial top-up if commit to save €50 net per month for 5 years before deadline (increasing each year with GAIE)
- Increasable to €2,000 for €250 net per month commitment
- Additional top-up based on marginal tax rate or basic rate if non tax-payer
- Encashment after 5 years based on own contributions only and with tax on gains
- Or convert to a pension policy
- No PRSI relief on contributions
- Initial top-up clawed back if contributions reduced
- Eligibility – Employees and Non-Earners not currently offered an OPS

How much do you need to save for a pension?

Annual Salary	Target Pension (in today's money)	Age you start saving				
		25	30	35	40	45
€20,000	€10,000	0%	0%	0%	0%	0%
€30,000	€15,000	6%	7%	9%	11%	14%
€30,784	€15,392	6%	7%	9%	11%	15%
€40,000	€20,000	9%	11%	13%	17%	22%
€50,000	€25,000	11%	13%	16%	20%	26%
€60,000	€30,000	12%	14%	18%	22%	29%

How much do you need to save for a pension?
(in addition to contributions of 6% of salary from age 25)

Annual Salary	Target Pension (in today's money)	Age you start saving				
		25	30	35	40	45
€20,000	€10,000	0%	0%	0%	0%	0%
€30,000	€15,000	0%	0%	0%	0%	0%
€30,784	€15,392	0%	0%	0%	0%	0%
€40,000	€20,000	3%	4%	4%	5%	7%
€50,000	€25,000	5%	6%	7%	9%	11%
€60,000	€30,000	6%	7%	9%	11%	14%

DC Schemes – Flexible Retirement

- DC already can more easily deal with deferred retirement
- Extend ARF option to DC members to facilitate flexible/partial retirement
- Gives retiree control independent of the trustees of the last employer's OPS
- ARF requirements would need to be reviewed, especially for ARFs taken out before 65
- Policy objective to facilitate deferred/flexible retirement, not drawdowns from age 50
- ARF Imputed Drawdown requirement should not commence until 65
- Tax Treatment of ARF assets in the Estate should be reviewed

Conclusions / Recommendations

Gerry O'Carroll

The Need for Change

- **Pension targets are very long-term**
- **The current model needs to evolve**
- **Economic/Financial/Social/Demographic change**
- **Diversify between State, Employers, Employees pillars**
- **Cultivate the “working on” pillar**

State Pensions

- Compulsion only justified to “minimum” level
- PAYG is acceptable to provide “minimum”
- System must evolve in response to life expectancy changes
- Some element of pre-funding may be necessary
- C = BD   Average Contribution = Average Benefit x Dependency Ratio

  or

  C + iF = BD   allowing for interest on fund

Private Sector – Employer Role

- Incentives are justified and necessary
- The risks/guarantees cannot "choke" growth
- Too much protection is outdated
- Level of protection (for each category) must be clearly understood
- Restructure protection – priority rule for pensioners needs to change
- Risk sharing and flexibility promote survival
- Blending of modest protection with top-up targets

Private Sector – Employee Role

- DC by definition
- Incentives necessary but reality says from age 45
- Flexibility and accessibility along ARF lines
- Education/communication to relate return to risk
- Education/communication on tax relief
- Tax reforms may be necessary
- Further and evolving product innovation

The New Wave

- Flexibility to encourage “working on”
- Job-sharing, part time, phased retirement
- State pension-early/late options
- Retraining
- State, employers and education system all-engaging

Pensions in Ireland: Addressing the Challenges

Questions / Comments