Society of Actuaries in Ireland

A Review of Retirement Income choices available from Irish approved Defined Contribution pension arrangements in 2015.

OR

“ARFs v Annuities”

Society of Actuaries in Ireland **November 2015**

Contents

Foreword

The genesis of this paper dates back to an event in June 2014 organised by the Retirement Actuary of the Future working group entitled "The Big Debate: Annuity vs ARF". The lively debate that ensued confirmed that there was sufficient interest in continuing further work in this area.

Separately, in January 2015, Tony Gilhawley suggested to the Society that it was an opportune time for a working party to be established to review the income drawdown regime and make specific recommendations to the relevant authorities. Amongst the drivers of the need for a review of a regime that was first introduced in 1999 to a particular cohort of retirement savers (i.e. 20% proprietary directors) were:

- the extension of income drawdown to all DC retirees in 2011 (the option had been extended to 5% directors and to AVC funds in 2000),
- ongoing tinkering with the imputed drawdown requirements,
- uncertainly around the AMRF set aside amounts and specified income requirements, as well as
- a general increase in the popularity of ARFs as an alternative to purchasing an annuity, in an environment of ultra-low interest rates.

Against this background a working party, led by Alan Hardie, was established in March 2015. The working party divided into two work-streams; one subgroup, led by Shane O'Farrell, took the lead in examining the wider topic of decumulation options from DC funds while the second subgroup, led by Tony Gilhawley, undertook a review of the existing ARF/AMRF framework.

On behalf of the Pensions Committee, I wish to congratulate the working party on producing a comprehensive paper and coming up with many positive suggestions on how to improve the system.

One highlight that the paper notes is the growing divergence in the profile of ARF holders from individuals with sizeable retirement pots focused on capital preservation and estate planning to individuals with more modest funds who are making use of ARF vehicles as a mainstream alternative to traditional annuities.

The paper examines the factors that individuals must consider in choosing between annuities, ARFs or a combination of the two. It is evident, from various research papers, that individuals do not appreciate the hazards associated with underestimating their individual life expectancy, while the industry is perhaps guilty of not fully espousing the longevity insurance aspect of annuities as it stresses their high cost in an environment of persistently declining yields and individuals continually focus on the potential capital loss in the event of early death.

Meanwhile we are yet to see how a full generation of retired workers manages income drawdown through the whole of their retirement and, in particular, how they make investment decisions in later life.

The annuity provides a baseline level of guaranteed income, while the ARF can:

- provide a flexible income drawdown option to perhaps facilitate increased discretionary spending early in retirement,
- enable investment in growth assets to provide some inflation protection throughout retirement, and
- allow flexible access to funds to cover long term care costs in late retirement, to the extent that the level of ARF funds permits.

While one might conclude that a combination of an annuity and an ARF may generally represent an optimum outcome, each individual's circumstances and risk preferences will differ.

This highlights the critical need for quality unbiased financial advice, both at the point of retirement in selecting appropriate options and product(s), and throughout retirement where income drawdown features. The paper makes some comments on the regulation of ARFs and the provision of advice surrounding benefit option and product comparisons and their relative merits.

Actuaries are well placed to be key figures in the continued evolution of this space – in both the product design area (and the paper examines product innovations in both the annuity and income drawdown markets in other jurisdictions with developed DC arrangements such as the UK, Australia, USA and Chile) and the advisory field.

The Society of Actuaries in Ireland could also have a role in educating consumers (and advisers), in layman terms, about concepts such as longevity pooling and mortality drag as well as providing tools that facilitate comparisons of the two products and demonstrate the potential for fund bomb out risk as well as the pitfalls resulting from the propensity to drawdown at too low a rate. The papers also identifies other areas where the Society could provide input such as liaising with the Central Bank on adviser competencies and further research on the rates of imputed drawdown and A(M)RF investment strategies.

Finally, the paper highlights some technical deficiencies in the existing income drawdown framework and makes some concrete and practical suggestions as to how the ARF regime in particular can be revamped. We are aware of ongoing discussions between the Revenue, the Pensions Authority and the Department of Social Protection on general DC simplification and we would be delighted to discuss the ideas set out in this paper with these parties.

Foreword

Aidan Kennedy

Chairman, Pensions Committee

Society of Actuaries in Ireland

November 2015

ARF option review

Introduction and extension of ARF option

The ‘ARF option’ was introduced with effect from 6th April 1999. It was based on the existing retirement annuity contract (RAC) product as an alternative to the only maturity option then available under the RAC of 25% lump sum and annuity purchase for the balance.

The ARF option allows full commutation of annuity rights (sometimes referred to as the ‘*traditional benefit option’)* under the relevant arrangement of which up to 25% can be taken as a lump sum. The balance of the commuted lump sum can then be transferred to a personal contract investment account held with a Qualifying Fund Manager (QFM), called an ‘Approved Retirement Fund’ (ARF), or taken as a taxable cash sum, subject to first complying with a €63,500 AMRF/annuity ‘set aside’ requirement if the retiree is not then in receipt of total pension/annuity income of €12,700 p.a.

The Minister for Finance in his 1999 Budget Speech in announcing the then planned introduction of the ARF option stated:

> *“the self-employed person will not be restricted to the one option on retirement of investing his or her accumulated pension fund net of the tax-free lump sum into a traditional type annuity;*
>
> *the self-employed person will have the option of retaining ownership at all times of the capital sum invested on his or her retirement to provide a retirement income; “*

The Department of Finance Internal Review of Tax Schemes (2005) in relation to the introduction of the ARF option stated:

> “*The intention of the ARF legislation was to develop an alternative flexible income stream in retirement which would obviate the necessity for annuity purchase,”*

So the initial official view of the ARF option was as a means to provide *an ‘alternative income stream’* to traditional compulsory annuity purchase.

The ARF option was initially introduced for RACs and 20% director members of occupational pension schemes (DB and DC), but has since been extended to now include:

- 5% + director members of occupational pension schemes, DC or DB;
- AVCs, DB or DC
- PRSAs; the PRSA also contains an ‘internal’ ARF type option, called the ‘vested PRSA’.
- DC occupational pension schemes for new schemes approved after 6th February 2011 and other DC schemes approved before that date if an appropriate rule change is made (for which no Revenue approval is required).

- Buy-Out Bonds (also known as Personal Retirement Bonds or PRBs), funded by a transfer from a DC occupational pension scheme.

The extension of the ARF option to DC occupational pension schemes in February 2011 has extended the option to a significant group who previously did not have such an option, i.e. employee members of employer DC occupational pension schemes.

The only areas left where the ARF option does not currently apply are:

- Funded DB occupational pension scheme benefits which are neither AVCs or 5% proprietary director member benefits.
- Unfunded DB schemes, e.g. public service
- Buy-Out Bonds funded by a transfer value from a DB scheme which relates to DB benefits which are neither AVCs or 5% proprietary director member benefits.

The ARF qualifying condition

As the ARF itself is a flexible drawdown product, i.e. the retiree can opt to withdraw up to 100% at any time[1], there is currently a qualifying condition to be satisfied before accessing the full flexible ARF drawdown. The condition can be satisfied in one of three ways:

- be in receipt at that time of specified income of €12,700 pa, i.e. pensions or annuities payable for the lifetime of the retiree; or
- invest or have previously invested a total of €63,500 from pension funds in an Approved Minimum Retirement Fund (AMRF) which is a constrained form of ARF up to age 75; or
- invest or have previously invested a total of €63,500 from pension funds in the purchase of an annuity payable to the retiree; interestingly the relevant legislation[2] does not require the annuity to be payable for the retiree's lifetime or to be an immediate annuity.

> The Working Party believe that there is merit in maintaining a qualifying condition to access full flexible ARF drawdown to guard against early dissipation of all retirement funds, which could defeat the main purpose of the ARF option, i.e. to provide an alternative (to the annuity) income stream in retirement.

[1] In effect because of the ARF imputed distribution provisions there is a minimum drawdown of 4%from age 61 onward up age 71 and 5% thereafter(6% at all ages where total ARFs and vested PRSAs exceeds €2m)

[2] S784C TCA 1997

Inadequacies of current qualifying condition

The Working Party believe that the current ARF qualifying condition suffers from a number of inadequacies:

- It is unduly complex; there are three different ways in which the condition can be met as outlined above.
- There is no rational relationship between €12,700 specified income and the alternative of €63,500 capital investment in an AMRF or annuity. For example, currently (November 2015) a lump sum of €63,500 would purchase a level annuity, guaranteed 5 years, of €2,663 pa for a male aged 65, with no survivor benefits.

  The €63,500 AMRF investment option is therefore a far weaker qualifying condition than the €12,700 pa specified income; in effect the system is currently biased in favour of choosing the €63,500 AMRF qualifying condition.
- The current specified income figure of €12,700 pa is just above the maximum State Pension figure of €233.30 per week, so that someone on the maximum State Pension cannot meet the specified income condition with the State Pension alone and would require the purchase of an annuity of some €568 p.a. to meet the condition.
- The current specified income test does not recognise pension income which may become payable in a relatively short period after exercising the ARF option, e.g. a State Pension starting at age 68 where the ARF option is exercised at age 65.

  In that case, the retiree may be required to invest in an AMRF at 65, which then turns into an ARF at age 68 when the specified income test is met.
- The €12,700 and €63,500 limits were set in 1999 and have not been increased appropriately over time[3] to allow for earnings or price inflation.
- The age 75 conversion of the AMRF to a full flexible drawdown ARF is too young given:
  - The increase in the State Pension Age to 68; there are now only 7 years between the start of the State Pension and the release of funds tied up in an AMRF.
  - General increase in longevity since 1999.
- The current AMRF design of allowing an optional 4% p.a. withdrawal in any one year, on a use it or lose it basis, is unduly restrictive in that it does not allow more flexible

[3] Apart from a temporary increase to €119,800 and €18,000 respectively between 6th February 2011 and 26th March 2013.

withdrawal patterns to cope with issues such as phased retirement and the need to access funds for special expenditures such as unexpected health expenditure.

- The specified income qualifying condition of €12,700 p.a. does not provide any protection for dependants, whereas a €63,500 AMRF protects the remaining AMRF fund for dependants on death.
- There is a potential loophole in the €63,500 annuity purchase option as the legislation does not require the purchase of an immediate or deferred lifetime annuity; the purchase of a temporary annuity would seem to meet this condition.

Increasing the €12,700 pa and €63,500 limits?

The Working Party do not believe that reverting the current €12,700 p.a. specified income and €63,500 AMRF/annuity purchase limits to the pre 26th March 2013 levels of €18,000 p.a. and €119,800 respectively is sensible as it would amplify the current inadequacies of the system by applying it to a wider range of future retirees.

For example, based on an AMRF amount of €119,800 the ARF option for retirees with maturing DC pots under €160,000 (the vast majority of DC employee retirements) would in effect be predominantly the 'AMRF option' and not the 'ARF option' assuming the 25% lump sum is taken at retirement; currently such a retiree with a €160,000 maturing DC pot could invest €63,500 in an AMRF and €56,500 in an ARF.

Mixed Benefit Options

Retirees may hold retirement benefits in a number of different arrangements when they come to take their benefits. The ARF option exists separately under each personal contract, e.g. PRSA or RAC, so that the ARF option can be exercised in one contract but not in another.

See Revenue Practice 23.2:

> *"Holders of more than one RAC may exercise a different option in respect of each contract. Similarly, holders of more than one PRSA may also exercise a different option in respect of each contract."*

However by the use of discretionary approval powers, Revenue impose restrictions on individuals who hold benefits in a number of occupational pension schemes related to the same employment. See Revenue Practice 23.2:

> *"Members of multiple occupational pension schemes relating to the same employment must exercise the same option in respect of each scheme. However, as noted above, an individual may exercise a different option in relation to AVC funds than that made in respect of their main occupational pension scheme benefits."*

This restriction therefore in effect prevents the use of the ARF option over DC scheme benefits where a retiree also has DB benefits related to the same employment.

However, Revenue allow an exception to this restriction in the case where a DB scheme is closed to future accrual and is replaced with a DC scheme, related to the same employment. In this case they will allow the ARF option in respect of the DC scheme benefits, but subject to restrictions as follows:

- The total pension equivalent value of benefits provided by both schemes cannot exceed the normal Revenue maximum, e.g. 2/3rds of final remuneration at normal retirement age (NRA) for service of more than 10 years, inclusive of retained benefits;
- If no lump sum is taken from the DB scheme, 25% of the DC fund can be taken as a lump sum; however in this case the maximum approvable pension which can be provided by the DB scheme is reduced by the DC lump sum taken divided by 9.
- If the maximum allowed lump sum is taken under the DB scheme, e.g. by commutation of pension, then no lump sum can be taken from the DC scheme; the entire DC scheme fund could be transferred to an ARF;
- If a lump sum taken from the DB scheme is less than the maximum allowed lump sum, then a further lump sum can be taken from the DC fund, to bring the total lump sum provided to the maximum allowed lump sum under the DB scheme. The maximum approvable pension which can be provided by the DB scheme is reduced by the DC lump sum taken divided by 9.

Apart from this concession above where a DC scheme was set up to replace a closed DB scheme, Revenue position is that *“the same retirement benefit option must be exercised in respect of all schemes relating to that employment”.*

Cash only option

While the retirement benefit option choice is often presented as ARF v Annuity, in fact in many situations there is a third all cash option:

- Under the ARF option in respect of the balance of the fund available to transfer to an ARF;
- DC scheme retirees:
    - Under the traditional benefit option where the maturity fund is less than the maximum lump sum allowable under the traditional benefit option, e.g. within 150% of final remuneration for a retiree with more than 20 years completed service at NRA.
    - In exceptional circumstances of serious ill health;

- o Where the maturing DC funds related to this employment are less than the single life annuity equivalent of €330 pa; and
- o Where the total retirement funds (from all sources, not just from the relevant employment) *after* taking the normal lump sum entitlement is less than €20,000.

There are other circumstances where the percentage of the maturing DC scheme fund which can be taken as a lump sum as normal commutation will be higher than the 25% maximum under the ARF option, e.g. where the maturing fund is less than 6 x final remuneration and the retiree has more than 20 years' service at normal retirement age.

Data on ARFs and AMRFs

QFMs are not under any obligation to make returns of their ARF/AMRF business to the Revenue or any regulatory authority. There are therefore no official current statistics on the numbers who take up the ARF option and/or the total value of funds currently held in ARFs, AMRFs and vested PRSA.

Department of Finance Review 2005

The Department of Finance Internal Review of Certain Tax Schemes (Section G) reviewed the operation of ARFs and the Revenue Commissioners collected data (in and around 2004) on ARFs from QFMs. The Report estimated the overall 2004/05 position of ARFs as follows:

Summary of ARF Creation and Overall/Average Fund Size

	Number	*Total ARF Investment, €*	*Average Fund Size*, €*
ARFs Pre-FA 2000	118	19,155,309	162,333
ARFs Post-FA 2000	6048	1,114,601,012	236,796
Total	**6166**	**1,133,756,321**	**234,975**
Withdrawals			
Regular	**348**		
Ad Hoc	**290**		

Source: Department of Finance Internal Review of Tax Schemes 2005, G.21

Other facts to emerge in the Review were:

- The average life company ARF size was €148,000, but for stockbroker ARFs, the average was €661,000 or some 4.5 times higher.
- The total number of life company ARFs was 5,682 while the number in stockbrokers (now MIFID firms) was 484.

- Only 348 of 6,166, I.e. 6%, ARF holders were taking regular withdrawals at that time, despite the ARF being introduced as an 'alternative income stream'. (This fact influenced the later introduction of the imputed distribution system to ARFs and vested PRSAs).

This low percentage of those taking regular income withdrawals from ARFs may be explained by the nature of those holding ARFs at that time, i.e. mainly the self-employed.

So by 2005 there was already evidence of a two tier ARF market developing; the insured market with a higher number but lower average size than MIFID firm ARFs.

Insurance Ireland 2013 year end estimate

While no further official data has been collected since 2005 on ARFs, Insurance Ireland data as 31st December 2013 relating to an estimated 60% of the insured ARF/AMRF market showed:

Market Level numbers as on December 31, 2013

Number of ARFs
Account Value (€m)
Average Size

Split by Size of Unit Value

Value of ARF	Number of Cases	Unit Value (€m)	Average Size	Percentage of Cases	Percentage of Value
0-50,000	9,711	246	25332	47.6%	10.4%
50,000-100,000	4,912	343	69829	24.1%	14.5%
100,000-250,000	3,616	565	156250	17.7%	23.8%
250,000-500,000	1,344	471	350446	6.6%	19.9%
500,000-750,000	436	262	600917	2.1%	11.1%
750,000-1,000,000	169	143	846154	0.8%	6.0%
>1,000,000	217	340	1566820	1.1%	14.3%
Total	20,405	2,370	116148	100.0%	100%

Number of AMRFs
Account Value (€m)
Average Size

Split by Size of Unit Value

Value of AMRF	Number of Cases	Unit Value (€m)	Average Size	Percentage of Cases	Percentage of Value
0-50,000	4,765	128	26863	38.5%	18.3%
50,000-100,000	6,647	454	68301	53.7%	65.0%
100,000-250,000	963	116	120457	7.8%	16.6%
250,000-500,000	0	0	0	0	0
500,000-750,000	0	0	0	0	0
750,000-1,000,000	0	0	0	0	0
>1,000,000	0	0	0	0	0
Total	12,375	698	56404	100%	100%

Source: Insurance Ireland

Grossing up for an estimated 60% sample size gives an estimate of the insured ARF market at the end of 2013 as follows:

- Total number of ARF/AMRF holders : 55,000[4]
- Total insured ARF/AMRF funds : €5bn

To this might be added a guestimate of MIFID firm ARFs of:

- Total number of ARF/AMRF holders : 1,400

[4] However this may involve some double counting of those who hold both an AMRF and an ARF.

- Total MIFID firms ARF/AMRF funds : €1bn

So at the end of 2013, there may have been total ARF funds of circa €6bn for about 56,000 retirees, up considerably from the €1.1bn and 6,200 ARF holders in 2004.

<u>It should be noted that the above figures are estimates and are purely for the purpose of estimating the size of the ARF market. No complete figures exist since, as mentioned above, there is no reporting requirement for QFMs.</u>

If we allocate the €1m + size insured ARFs to the MIFID firm ARF category, we see that there are two very different ARF markets (i.e. excluding AMRFs):

Smaller ARF market (all insured)	About 34,000 holders with an average ARF pot of around €100,000; some 70% of these have an average ARF pot of less than €70,000.
Larger ARF market (MIFID + €1m + insured ARFs)	About 1,800 holders with an average ARF pot of just over €800,000

So the majority, by number of current ARF holders, are likely to have an average ARF pot of less than €100,000. Some of these may also have invested up to €63,500 in an AMRF.

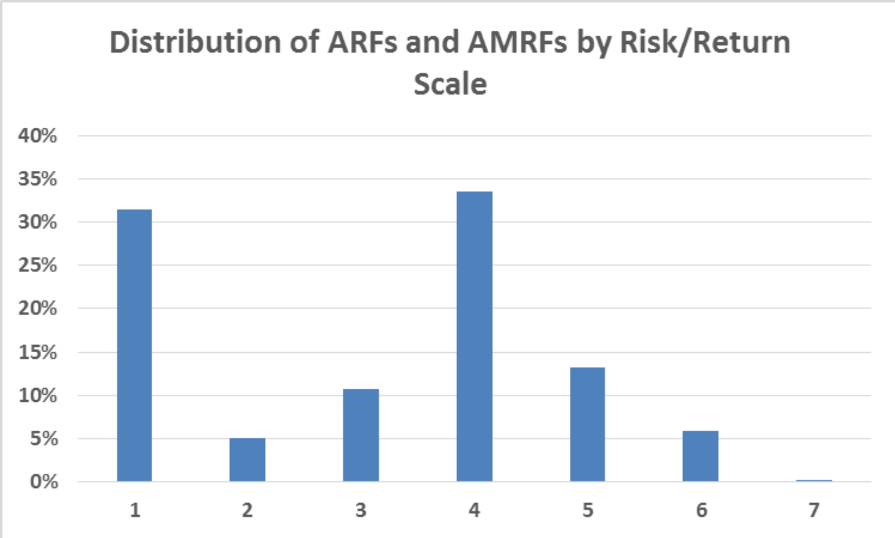
Investment of ARF funds

Data supplied to us by some life assurance QFMs indicate that in respect of some €2.6bn of AMRF and ARF funds, the two most popular asset allocations were:

- Cash or cash like funds (capital protected) : 44%
- Managed type , where the asset allocation is determined by the fund manager : 44%
- Single asset type fund : 12%

This analysis varied little by ARF size.

Using a broad 1 to 7 risk/return scale (not ESMA) adopted by the QFMs, the split of ARF and AMRFs funds was:



Again the split is dominated by two main groups, a low-risk group and the managed or mixed fund group. Scales 1 to 3 inclusive accounted for some 47% of the ARF and AMRF funds surveyed.

Regulation of the ARF option and ARFs/AMRFs

No approval process

Despite being called an 'Approved Retirement Fund', in fact there is no regulatory approval process for ARF structures. This must be confusing to consumers.

Reporting

There is currently no requirement for QFMs to report to any regulator details of the ARF/ AMRF amounts held by them.

Pensions Authority

The Pensions Authority has no function in the regulation of ARFs, as its remit extends only to occupational pension scheme, RAC trusts and PRSAs.

While it has a regulated role in the approval of PRSA products, this role has no specific obligations in relation to regulating vested PRSAs as a drawdown vehicle.

Central Bank

The Central Bank prudentially regulates life assurance companies and MIFID investment firms established in the State, which are the current main ARF/AMRF providers. It also regulates the conduct of business of insurance and investment intermediaries who advise on and arrange investments in ARFs/AMRFs.

An ARF or AMRF is not itself a financial instrument under MIFID or the Investment Intermediaries Act, but what an ARF account holds, e.g. an insurance policy, securities, etc. is likely to be.

Therefore, the Central Bank conduct of business regulation (the Consumer Protection Code mainly) contains no specific requirements in relation to advising on generic ARF v Annuity v Taxable cash options or ARFs in a generic sense, and the Code's impact on retirement benefit options advice is in the main likely to be restricted to the suitability of particular investments for an ARF account or choice of insurer for an annuity, rather than whether the ARF option was or continues to be the most suitable retirement benefit choice for that consumer.

Adviser competence requirements

The Central Bank Minimum Competence Requirements apply to firms employing individuals to act on their behalf in the provision of advice to consumers on retail financial products.

For this purpose, the term 'retail financial product' is defined as including insured ARFs but not MIFID firm ARFs, and also includes annuities.

There are a number of specific competences which refer to ARFs:

- *To explain the main legislative restrictions on the investment and operation of and the benefits arising from occupational pension schemes, AVCs, retirement annuities, ARFs, AMRFs, Buy Out Bonds and Personal Retirement Savings Accounts.*
- *To explain what an ARF portfolio is, and identify who is entitled to transfer funds into an ARF.*
- *To identify the main statutory restrictions on ARF, PRSA and occupational pension scheme investments.*
- *To demonstrate the taxation treatment of distributions from an ARF.*

While annuities are also specified as a 'retail financial product' none of the specified competences require an ability to compare the relative merits of the ARF and Traditional Benefit options.

Revenue Commissioners

Apart from normal tax revenue collection on ARF & AMRF distributions, Revenue have a limited role and no discretionary powers in relation to the operation of ARFs & AMRFs; just the approval of the ARF & AMRF application and transfer forms.

Regular review

There is currently no requirement in legislation or the Central Bank's Consumer Protection Code to regularly review an ARF or AMRF account, say every 3 years, to illustrate to the retiree the progress of his or her fund and the likely future retirement income stream the ARF or AMRF may produce.

Consumer Disclosure

Insured ARFs & AMRFs, but not MIFID firm ARFs and AMRFs:

- are covered by the Life Disclosure Regime in relation to the disclosure of charges and sales remuneration at the point of sale of the relevant policy to be held in an ARF or AMRF account, and the provision of an annual statement of value.

  Section 15 of the ASP LA8 contains specific disclosure requirements in relation to policies to be held in an ARF account, including:

  - illustration of periodic withdrawals at a gross return of 2% and 6% pa (recently reduced to 5%);
  - where periodic withdrawals are illustrated, the illustration must show withdrawals escalating @ 3% pa.
  - disclosure of the 'bomb out' period where the illustration provided (e.g. periodic withdrawals escalating at 3% pa) shows the eventual depletion of the fund.
  - The annual statements required by Consumer Protection Code post sale information provision 6.16.

However, there is currently no requirement on QFMs to provide a SORP type statement.

Neither is there a requirement for advisers to conduct a regular review of ARFs or AMRFs for their clients.

There are no specific ARF disclosure provisions applying to MIFID firms when providing ARFs to clients, but normal MIFID disclosure requirements apply to the investment management of ARF funds.

Summary of regulation

It would be fair to state that the provision of advice on the current ARF option v Traditional Benefit option is largely a 'regulation free' zone and few if any regulatory requirements apply to the ongoing operation of ARFs.

This position can be contrasted, for example, with the extensive approval, reporting and regulatory provisions which apply to PRSAs, including:

- A product approval process;
- Restrictions on product charges;
- The role of PRSA actuary;
- Disclosure of point of sale and regular information to PRSA holders;
- A default investment strategy; and
- Quarterly PRSA provider reporting obligations to the Pensions Authority.

Sources of Consumer Advice on retirement options

Publicly available advice

There is no direct equivalent in Ireland of the UK Government funded Pension Wise or the Pensions Advisory Service services, which provide dedicated independent impartial information on retirement benefit options and choice.

However, there are two much more limited sources of information on the ARF and annuity options in Ireland:

- The Competition and Consumer Protection Commission's consumer help website (www.consumerhelp.ie) does provide within Pensions – Choose Products section advantages and disadvantages of ARFs and Annuities, separately.
- The Pensions Authority LifeCycle website provides some limited information about the ARF option and the tax on ARF/AMRF withdrawals.

Professional advisers

We have already noted the absence of a regulatory requirement to compare the relative merits of the ARF and the traditional benefit options. This of course doesn't prevent financial advisers from assisting customers beyond what is prescribed but we note the absence of tools and education to help them do so.

It is hard to envision a useful advice process at retirement that doesn't include information on life expectancy and the likely incidence of charges in retirements. Advisers are hampered in this regard by:

- The absence of basic probability training;
- The absence of suitable mortality tables to correctly reflect the population who have a decision to make;
- Lack in the marketplace of generally available ARF projection tools, to adequately illustrate the bomb out risk to consumers; and
- The absence of solid analysis on the pattern of expenditure of retirees over their retirement.

Professional advisers need to also consider different commission rates in the market.

Market/product bias

There exists the potential for market / product bias in favour of one option over the other due to differing commission structures.

- Higher initial sales remuneration offered by providers on ARFs and AMRFs (up to 5%) as compared with a typical maximum of 3% on annuities;

- Trail commission option provided to insurance intermediaries by life companies under ARFs and AMRFs (by way of a direct corresponding equivalent reduction in value from the ARF account), typically a choice of 0.25% or 0.50% pa;
- Ability to re-sell an alternative ARF and get further initial commission (possibly after a 5 year early encashment penalty period has elapsed);
- A significantly higher number of ARF providers (QFMs) than annuity providers; and
- While some life assurance companies and insurance intermediaries can offer either an annuity or ARF to a client, MIFID investment firms may be less likely to offer the annuity option to their clients as their main business is the management of investment funds.

Imputed distributions and regular drawdown

It is understood that the vast majority of ARF holders take annual withdrawals sufficient to avoid an imputed distribution applying to their ARF in that calendar year, and no more, i.e. typically they withdraw 4% (if aged 70 or lower in that year) or 5% (if aged 71 or more in that year) of the market value of their ARF in December each year.[5]

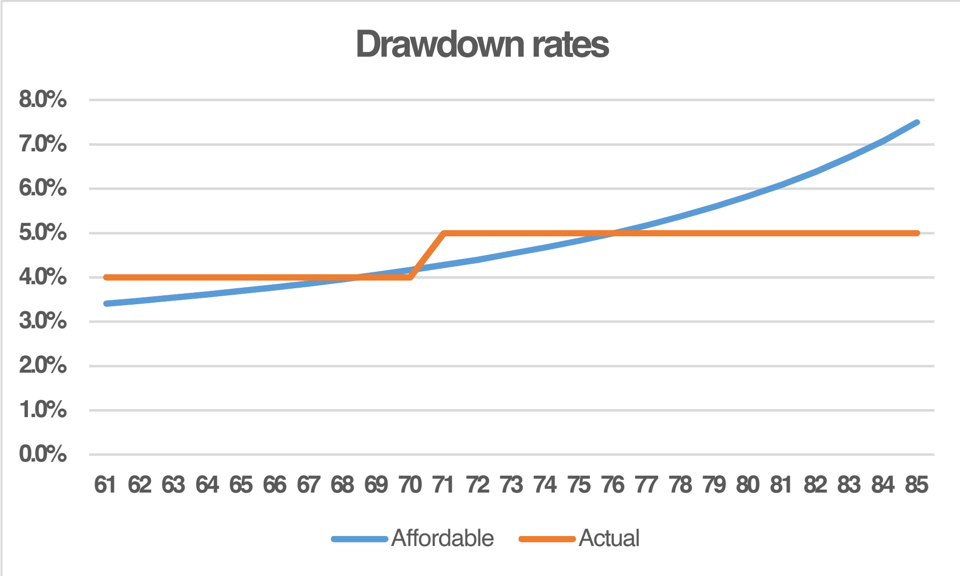
Very few withdraw at a different rate to the imputed distribution rate. This is probably because of a number of related factors:

- A desire to preserve capital as far as possible; the consumer’s thinking may be that if withdrawal are being taken as a fixed percentage of the value of the ARF, if capital can be preserved then so will future retirement income;
- A desire to preserve capital as far as possible for a spouse/partner and/or children to inherit on the death of the ARF holder;
- Absence of any guidance from QFMs or advisers on what drawdown rate could reasonably be taken even if the ARF holder was prepared to expend their ARF capital over their expected lifespan.

For example, if we took an expected mortality age of 100, say, and assumed the ARF could earn an after charge return of 1.5% pa[6], a comparison of the affordable drawdown rate at different ages (assuming the ARF will be fully expended by age 100) and the current imputed distribution drawdown rate is as follows:

[5] The valuation date to determine the imputed distribution to apply in that year, if any, is 30th November.

[6] Representing a likely lower risk/return investment approach.



The chart suggests that with a low/lower risk/return profile, ARF holders are probably being forced by the current imputed distribution system to overdraw up to about 75, but could afford to take higher withdrawals than the imputed distribution rate from late 70's onwards.

Deferral of annuity purchase

An ARF is sometimes recommended as an annuity purchase deferment option, i.e. the retiree wants secure retirement income but the retiree/adviser may feel that now is the 'wrong time' to buy an annuity because of low absolute annuity rates. The retiree/adviser may therefore decide to stay invested in the ARF waiting for annuity rates to go back up though increased bond yields and/or higher rates available at older ages.

Of course such a strategy over the last number of years would have been highly unfavourable to the retiree and contains significant risks for retirees through a combination of a likely low risk/return investment approach combined with mortality drag, i.e. the longer the retiree waits to buy the annuity, the less longevity insurance there will be in the annuity rate, even if all other things remained equal (e.g. bond yields and longevity generally).

Group ARF Structure

It may be useful to consider allowing trustees of DC occupational pension schemes to provide, if they wish but not compulsory, the AMRF and ARF option 'in scheme', so that a DC scheme retiree could take their lump sum at retirement and leave the balance in the DC scheme as an AMRF/ARF and take drawdown from the scheme in retirement.

This might allow some retirees to continue to benefit in retirement from:

- likely lower scheme charges than would apply under individual AMRF/ARF person contracts; currently DC scheme retirees are obliged to leave the DC scheme and enter into personal ARF contracts with likely higher charges than had applies to the accumulation of funds.

- independent trusteeship governance;
- pooled investment funds;
- post retirement type default investment strategies; and
- advice; which the employer or scheme might contract with an adviser to provide at the point of retirement and continuing in retirement.

In addition, the possibility of a group AMRF/ARF trust structure (somewhat akin to the current Trust RACs) could be considered, where individual retirees with some common bond, e.g. through a representative group such as trade unions, credit union, trade bodies, former employer, etc., could group together under a trust arrangement and obtain the possible benefits of:

- likely lower group charges than would apply under individual AMRF/ARF person contracts;
- independent trusteeship governance;
- pooled investment funds;
- post retirement type default investment strategies; and
- advice; which the sponsor of the trust might contract with an adviser to provide advice at the point of an during retirement, the cost of which might be charged to the trust fund.

Treatment for bankruptcy/insolvency purposes

An ARF is a personally owned asset and hence can be recovered in full by creditors in certain circumstances, subject to a PAYE tax charge on withdrawal of funds from the ARF. Annuity payments can also be received by creditors but only for the period of insolvency/ bankruptcy.

Not an either/or choice

The ARF v annuity choice shouldn't be an either/or choice. However:

- The ARF option itself does not contain a direct annuity option, i.e. under the ARF option after taking the 25% lump sum and meeting the AMRF/annuity requirement, if applicable, the only two remaining options with the balance are transfer to an ARF or take as a taxable cash sum.

  While market practice assumes and acts as if there was a third annuity option within the ARF option, technically in the ARF legislation there isn't.

- There is no provision in the ARF legislation to allow the withdrawal of funds to purchase an annuity, without the withdrawal being treated as a taxable distribution from the ARF.

  Consequently, an ARF holder who wants to annuitize in part or total must purchase an annuity to hold as an asset of the ARF, i.e. the annuity is wrapped inside the ARF structure which must then continue for the lifetime of the ARF holder.

  However this is a cumbersome process as :

  - the ARF still continues as a holding vehicle around the annuity contract; it is not terminated.
  - on death any death benefit under the annuity (e.g. capital protected annuity) is taxed as a post death ARF distribution.

  So in effect there is no means at present for an ARF to be terminated by buying an annuity with the full residual gross funds in the ARF.

Introduction

Whilst all the classical economic theory (for example, the original work of Yaari 1965), suggests annuitisation is optimal behaviour for a risk-averse person faced with the uncertainty of their own longevity, the practical evidence suggests that people view annuities as unappealing and actually risky in terms of capital losses. This is known as the Annuity Puzzle.

That is, some people view pension saving as not mainly about providing a steady and stable income in retirement for their lifetime but a means of inter-generational wealth transfer. This seems especially so in Ireland. This is despite the fact the next generation are usually better educated, better fed and wealthier and will live longer than their parents! (To date, however, the size of ARFs for many retirees is still relatively small and therefore inter-generational wealth transfer may not be an important consideration for all retirees.)

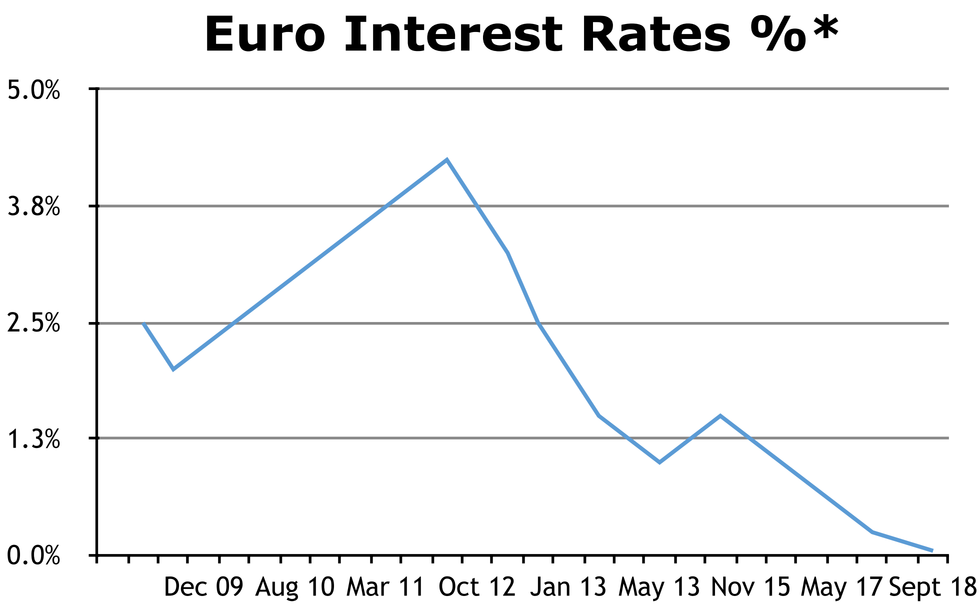
Even If inter-generational wealth transfer is actually a driving force behind the ARF, it is arguable that the best outcome in terms of consumption maximisation for the person is very much in doubt; there is a conflict here between their needs and their wants.

People also fear locking money in without any flexibility or recourse to extra money for a rainy day, an unknown future need or increasing health requirements at older ages.

Like Mao's comments on the French Revolution, it's too early to tell yet how this break away from annuities will actually turn out. In truth, we have not yet even seen even one single set of outcomes for a whole generation in this new model of self-retained risk (in Ireland, UK, Australia or the United States). Up to now, the vast bulk of pensioner experience has been with DB or State paid benefits, and we are only starting to see the first drawdown people reach middle and older old age under any of the regimes.

Low Interest Rates

Whilst low interest rates are often seen as offering poor value for annuities, the truth is more subtle: all forms of pension provision are equally impacted by low interest rates and expected returns-the relative value on offer is not changed by changes in the risk-free rates as all returns should be reduced. There is also strong evidence from other countries (especially Australia) that even in modestly higher interest rate environments, annuities are not popular where people have free choice. Once annuities become a niche product, a herding effect means they can quickly become redundant.



*ECB Refinancing Rate

The aversion to annuities cannot be put down to current low interest rates and longevity assumptions. Witness this citing from older Actuarial papers:

"The new options have been introduced in the context of:

Low annuity rates: rates have fallen to their lowest nominal level for over 30 years due to Euro level interest rates and improved longevity"

Society of Actuaries in Ireland, Retirement Options Committee Report Nov 1999

"Customers (and their representatives in the press) appear to regard conventional annuities as inflexible and poor value"

Reinventing Annuities, Wadsworth, Findlater and Boardman to The Staple Inn Actuarial Society, Jan 2001

"In the current environment of poor annuity rates, impaired annuities-..-offer an alternative route"

Annuity and Insurance Products for Impaired Lives, Ross Ainslie FFA May 2000

These observations were made at a time of about 5/6% interest rates in Ireland and longevity assumptions which, in retrospect, were loss-making for life insurers given the rapid improvements that have since emerged.

Optimal Retirement Results

The Working Party recognise that the optimal results will vary considerably based upon the person's circumstances and risk tolerances, but some combination of ARF and Annuity would seem optimal as an "efficient frontier" of risk and reward trade-off (as in any modern portfolio theory). We discuss models here.

Annuity review

Many advisers are not strong enough in highlighting the risks of no longevity protection: the Australian paper[7] shows the inefficiency that can result. There is generally no management of longevity risk at all in various drawdown products. All of the economic theory suggests pooling the uncertainty here avoids downside risk but in practice this does not happen. There is an advice complexity issue here together with a challenge to both regulation and, more importantly, adviser attention.

Other than Variable Annuities (which suffer from high complexity and possibly high expenses), there is no way longevity is pooled other than via a traditional annuity (and this implies the investment guarantee too) as longevity swaps do not work at the single life level.

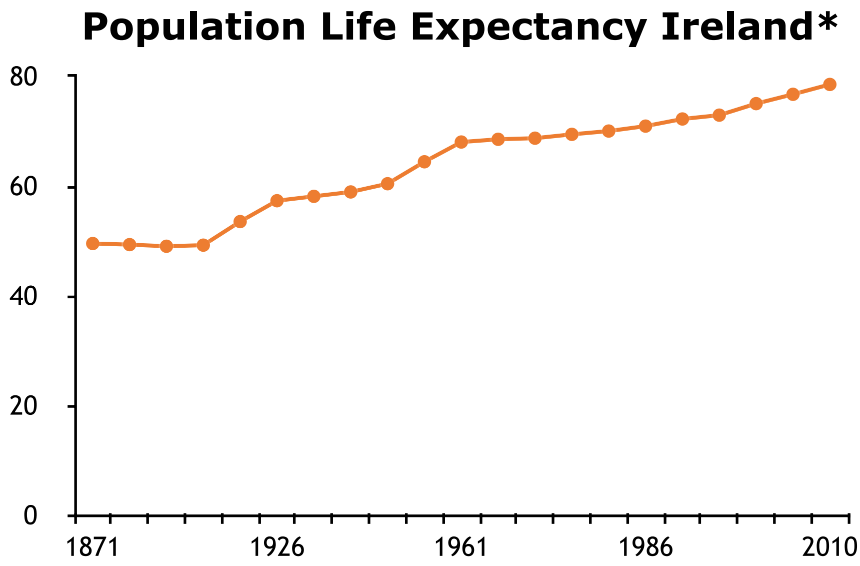
The Working Party propose the following areas of possible improvements:

- Product providers and Revenue authorities need to agree a formula to allow some element of flexibility/access to cash to annuities (to the extent this is possible under the regulations)-for instance, in the US this is possible under some products if you have no health care arrangement.
- Encourage a more subtle post retirement approach of a balanced portfolio with ARF and Annuity playing different roles rather than an either/or solution.
- Encourage greater awareness and modelling of longevity risk not just at retirement but throughout retirement if a drawdown is used.
- The purpose of retirement saving in giving the retiree the best quality of life and stable income) should be more centre stage rather than tax efficient inheritance.
- ARF products should allow a form of post-retirement lifestyling as a way of de-risking into retirement.
- Encourage greater advice around the psychology of the post-retirement choice, to ensure that retirees are making decisions which maximise the quality of their retirement lifestyle.

Longevity Risk

At retirement the risk of outliving your savings and/or leaving no inheritance (or vice versa, underspending and leaving an unnecessary inheritance) is influenced by many factors including uncertain investment returns, future inflation, inadequate savings built up and uncertain life expectancy. Longevity experts have consistently failed to estimate population life expectancy with any great accuracy over time and the challenges for an individual are even greater.

[7] Australian Government Actuary Department, Towards more efficient retirement income products



*Source: CSO website

The chances of someone currently aged 60:

- Reaching age 75 is 4 in 5 for males and 9 in 10 for females;
- Reaching age 85 is 1 in 2 for males and 2 in 3 for females;
- Reaching age 95 is 1 in 9 for males and 1 in 5 for females.

Reference: CMI Personal Pensioners, Males and Females, Vested - PPMV00 and PPFV00.

The risks in assessing life expectancy are:

- Systemic Risk – How do we project the general mortality rates of a population into the future and estimate how they may differ from today? What factors will influence it and by how much?
- Model risk – Are we using an appropriate model for projecting mortality rates and have we parameterised it suitably?
- Idiosyncratic risk – Even if we know how future mortality rates will develop and we have built a suitable model to estimate it into the future, there is still the random variation of life expectancy for an individual from the overall population. At the individual level, this is by far the greatest source of risk.

Factors Influencing Life Expectancy

Recent increases to life expectancy can be attributed to improved diet, access to food, availability of basic healthcare, medical progress, better basic hygiene, healthier lifestyle, absence of global military conflicts, absence of pandemic crises and more scientific advances. The level of improvement has varied by social class, gender and other factors, confounding any simple average improvement. Very few of these were predicted 200 years ago and this makes any assessment of future life expectancy very challenging as we do not know what other factors could arise into the future.

Other research is more pessimistic and refers to current obesity levels, poor diet, global warming and biological limits to ageing that will slow or even roll back some of the improvement in life expectancy in the future. There is therefore no consensus view by experts so how can an individual be expected to make an assessment of their own life expectancy?

Research[8] has indicated that variation in life expectancy causes are 25% genetic, 25% non-genetic decided before age 30 and 50% non-genetic decided after age 30.

Individual Assessment and Perception of Life Expectancy

Some of the factors impacting the life expectancy for an individual are gender, geographical location, social class, level of income, year (and, according to some studies, month[9]) of birth, healthcare, nutrition lifestyle, education, housing, employment/work, medicine, new diseases. In a survey[10] on the factors influencing their expectation of their own life expectancy people responded with their own family history and personal health as the main influences. The average population life expectancy is not an influence on their expectation of their own life expectancy. In another survey[11] people responded with their health and smoker status as influencing factors and did not select obesity, education or social class from the list of contributing factors. It is not surprising therefore that if people do not appreciate the factors influencing their life expectancy then they are unable to estimate how long they might live for.

Other surveys[12] have supported this and consistently report that individuals at retirement underestimate their life expectancy by approximately five years. People often assess their longevity based upon their parent’s lifespan, but fail to account for the general improvements that have occurred in the intervening 40 years or so.

Understanding Life Expectancy

Individuals often have general fear and difficulty in planning more than 10 years into the future. A survey by IFS[13] found that almost 60% of individuals approaching retirement age

[8] David Blake, Pensions Institute, Cass Business School

[9] Journal of Aging Research, http://www.ncbi.nlm.nih.gov/pmc/articles/PMC3236478/

[10] Society of Actuaries, USA, (with Mathew Greenwald & Associates) and also the Employee Benefit Research Institute (EBRI)

[11] Alison O’Connell, Institute of Policy Studies, Wellington, 2010

[12] O’Brian, Fenn, and Diacon, 2005, AND Making the System fit for purpose, International Longevity Centre, UK, 2015.

[13] Institute for Fiscal Studies, Expectation & Experience of retirement, 2012

have never considered how long they might live into retirement or what income they will need. People do not easily value payoffs into the distant future as the promise of pleasure tomorrow is perceived to mean pain today. Many surveys have shown that people are not skilled in understanding life expectancy or in financial planning. For example, ILC[14] research reported that 50% of those surveyed did not know what an annuity was and 50% knew that the best way to limit tax was to slow down drawdowns. Improvements in mortality rates over time and an understanding that an individual's life expectancy changes as they age are other factors that can cause difficulty for individuals in understanding their life expectancy. For example, a male at birth has a life expectancy of 76.8 years but a male aged 65 is expected to live to 81.6 years.

These combined can lead to myopic behaviour and decision making by individuals and increase the risk of running out of money later in life. For example individuals are vulnerable to the all too alluring lump sum at retirement as against managing an income stream in retirement.

Risks with Inaccurate Assessment of Life Expectancy

Individuals may overestimate their life expectancy and risk not spending all their savings, having a lower standard of living and leaving an unintended inheritance. For example, the (Australian) Government Actuary Department[15] estimate that on average 31% of an individual post retirement account will remain after they die assuming the drawdown income according to the prescribed drawdown factor. Alternatively an individual may underestimate their life expectancy and risk running out of savings and leaving little or no inheritance. The significance of these risks was less in the past when state benefits, defined benefit and compulsory purchase annuities were more common. These arrangements remove the longevity risk from the individual in contrast to Defined Contribution schemes and ARFs.

There is no time for trial and error in making retirement decisions. However, since bad results are likely to emerge after a period of years rather than immediately, there is a delay before the effects of poor decision making are recognised. In the future it may be the case that people gradually adjust downwards their consumption and expectations if funding runs low (meaning the impact of longevity risk on their retirement savings is less apparent in society generally than might be imagined). Do people slowly experiencing reduced wealth tend to cope better (and more quietly) than those who suddenly feel the effects of a drop?

On other hand, the ability to manage your own retirement account may make it more tolerable as it's not a sudden loss.

[14] Making the System fit for purpose, International Longevity Centre, UK, 2015

[15] Australian Government Actuary Department, Towards more efficient retirement income products

Premature retirement greatly increases the risk in assessing life expectancy and adequacy of retirement funds; individuals can work for as little as 30 years and need to fund a retirement for up to 40 years.

Requirements & Solutions

In a recent survey by ILC, 75% of respondents describe themselves as "risk averse" and prefer a "stable income in retirement" over one that could vary up or down. This is contrary to rates of annuitisation in Ireland and elsewhere (In Australia and the USA less than 10% of individuals buy annuities at retirement). This may be down to individuals being loss averse and they see buying an annuity as losing more than they gain. Individuals often see the solution to living longer as simply reducing expenditure, eliminating debt before retiring, dipping into savings, depleting savings and re-mortgaging their home.

Pooling of longevity risk (traditionally provided in DB Schemes, annuities) can reduce the idiosyncratic risks that an individual faces at retirement. It can help to reduce the fears that the individual has about becoming a burden on children. For all their many flaws, the role of much criticised Defined Benefit schemes in providing a vehicle for pooling longevity between lives has to be commended.

Some products such as annuities aim to mitigate longevity risk by offering a secure income in retirement but are perceived poorly by many retirees (and have for a long time). This has been intensified by the current low bond yields but there are also contributing factors like:

- loss of liquidity,
- secure state pension income available,
- perception of unfairly priced annuities,
- no lump sum inheritance payment,
- personal considerations of wanting to cover lumpy health care,
- fiscal incentives for other drawdown products,
- perception they can manage drawdown better,
- mistrust of insurers,
- psychological positive wealth feeling of owning an apparently large fund,
- annuities seen as risky gambles where potential losses loom larger than potential gains (early death over emphasised and little value put on guarantee period or reversion),
- no previous experience of this decision for retirees and they display inertia when faced with the unknown; the irreversible annuity path seems to deserve caution,

- inability of people to understand longevity improvements and costs of guarantees, and
- a sense of pressure from timing risks given the decision is once in a lifetime (although if matched out in appropriate bonds the actual timing risk is much reduced).

Psychology of Post Retirement Choice

The choices available to members who are retiring can be distilled down to an Approved Retirement Fund or annuity for life (with or without guaranteed period) and with or without a reversionary pension. Each individual could opt for a mix of both of these options but to explore these options we will focus on a simple either / or choice.

Behavioural Economics

There are a number of well documented biases (also known as heuristics) which explain non-optimal decision making by individuals in their financial decision taking. Some of the main ones which apply to the choice at retirement are as follows:

- **Anchoring Effect**

  In determining the value for money of an annuity at retirement, individuals (and their advisers) will need to make an estimate of future investment returns and life expectancy. Well established anchors (say 20 years for life expectancy or 5-10% for investment returns) could severely impair decision making as individuals feel that making allowance for longer life expectancy or lower investment returns is being over cautious.

  This anchoring effect also impacts annuity pricing. Advisors (and even actuaries) struggle to move their anchors around “reasonable” annuity pricing of the past and cannot see current annuity pricing as value for money. Will it take a whole new generation for whom current “low interest rates” are the “norm” for this to wear off?

- **Framing Effect**

  The annuity purchase decision has been framed poorly by insurance companies and advisers. Consumers view the purchase of an annuity as a risky move which only pays off if you live long enough rather than a risk averse move of guaranteeing income for as long as you live. The ARF vs Annuity decision has also been framed as retaining ownership and keeping control (ARF) versus giving up ownership and surrendering control (Annuity).

- **Overconfidence**

  Retirees are overconfident (at the point of retirement) about their (and their advisers) ability to manage an investment portfolio to meet their future needs in retirement. The variance of life expectancy for an individual makes this a difficult task as the individual ages and there are well documented challenges around under spending in retirement as individuals are forced to be conservative.

- **Irreversible decisions**

  People like to be in control of their investments and do not like making a single investment decision which they cannot change for twenty or thirty years. People will put off an irreversible decision to another day if they have any doubts on the basis that they can always opt in again next month.

- **Loss Aversion**

  Retirees do not like the large losses they perceive will occur should they die in the years immediately after an annuity purchase. There also may be positive psychological benefits about having access to a sum significantly higher than an individual has had access to before.

Assessment of different post-retirement models in use in the world

There are currently already a number of products available which try to alleviate the previously mentioned risks and uncertainty in post-retirement. These products include:

Annuities

Standard annuities are insurance products where in exchange for a sum of money, they guarantee that the consumer will receive a series of payments. These payments may be either level or increasing periodic payments for a fixed term of years or until the ending of a life or two lives, or even whichever is longer.

Deferred Life Annuity (DLA)

A deferred life annuity provides a guaranteed income stream from a trigger age in the future. As with immediate annuities the guarantee requires capital to support it and can make them relatively inefficient. However they may be used a part of a combination with an ARF at retirement where a part of a retirement fund could purchase a DLA to be paid from age 85. This DLA would give the individual some longevity protection along with more freedom in early retirement via the ARF.

Group Self Annuity (GSA)

Annuity purchase rates at retirement from the Account Based System in Australia are very low. Research by the Government Actuary Department[16] into a new type of Group Self Annuity (GSA) has indicated the value of pooling of longevity risk. GSAs allow retirees to pool their retirement savings together and to receive an annual pension based on a prescribed formula which depends on the number of members in the pool surviving to older

[16] Australian Government Actuary Department, Towards more efficient retirement income products

ages. This helps to provide some longevity protection to members and overcomes idiosyncratic risks.

Retirement incomes could be up to 40% higher for individuals compared to the required minimum drawdown factors. A GSA does not provide any inheritance payment on death as it redistributes money that would otherwise be left. The GSA also works more efficiently for larger more homogenous pools of individuals. Unlike an annuity it only transfers some longevity risk from the individual to the group with investment risk and systematic longevity risk remaining with the individual. Further research into the optimum balance between the need for scale to benefit from pooling and at the same time giving the individual an association and appreciation of value for money and security in the GSA is required.

Variation on the GSA explored in this research might include differing GSAs by investment profile (Cautious, Moderate, and High) with a trade off with the income level provided.

A summary of their analysis is included in the table below. The Account Based Product (ABP) is a post retirement drawdown fund in Australia with prescribed minimum drawdown rates (aimed at broadly maintaining a level nominal income through retirement). The Income relative to ABP shows the total income that a retiree could expect under the various products relative to what they would expect to get from the ABP. (Note, the ABP is expected to have a residual fund of 31% remaining for the average member).

Product	Annuity	GSA	ABP + GSA	ABP + DGSA	ABP + DLA	ABP
Income relative to ABP	119%	140%	130%	129%	114%	100%
NPV income relative to Price	82%	97%	90%	89%	78%	69%

The above table illustrates:

- The higher income available if no inheritance is required as is the case with the ABP
- The additional income available if products with no guaranteed income are used (GSA, ABP + GSA, ABP + DGSA)
- The cost (in terms of expected income received) relative to the purchase price of requiring an inheritance (ABP) or of guaranteeing income in retirement (Annuity, DLA).

However, it has to be noted that the GSA has some challenges including the governance aspects for the providing life office in ensuring equity in a cross-subsidy environment and complexity (in this way it’s akin to a With Profits fund).

Longevity Swaps

Longevity swaps have become popular with larger employer-sponsored defined benefit schemes in the UK and as a means of life office reinsuring longevity risk. A scheme will swap a series of unknown actual future pension payments under their scheme for a series of known future pension payments based on a mortality curve (either scheme specific or population). The administration set up costs and risk premium costs mean that this is only suitable for large scheme (in excess of €300m). Given the added selection risk for individuals, it is unlikely that insurers will be able to offer such products at an individual level. When the life insured is also the counterparty there are clearly also challenges!

Longevity Bonds

Longevity bonds are bonds issued by governments where the future coupon payments are based on actual longevity experience over time for the population. These offer insurance companies an asset to help hedge longevity risk and may result in better annuity rates in the market for individuals. Theory would not allow an individual to spread their own longevity risk however.

Tontine Insurance – a historical example of longevity pooling

A tontine is an investment plan for raising capital, devised in the 17th century and relatively widespread in the 18th and 19th centuries. It combines features of a group annuity and a lottery. Each subscriber pays an agreed sum into the fund, and thereafter receives an annuity. As members die, their shares devolve to the other participants, and so the value of each annuity increases.

This was a popular insurance from the 1800's but is now illegal in most countries. Interesting research[17] into the psychology of tontines and their popularity can provide a useful comparison to annuity purchase today. They were often sold to peer groups. Some differentiating attributes were comparative optimism of individuals versus peers, on early death benefit goes to your peers and not an insurance company, greater perceived transparency and fairness, inter-temporal comparative optimism and cross subsidy between those dying early and those living longer more acceptable when the lives in the group are identifiable e.g. all engineers. (This is one of the attractions of the GSA mentioned above if restricted to similar lives and one of the lost advantages of DB plans.)

In addition to looking at what is available at the moment it may also be useful to look at potential product development by observing regimes and outcomes in other countries. Consequently we have looked at a number of post retirement models including UK, Australia and US.

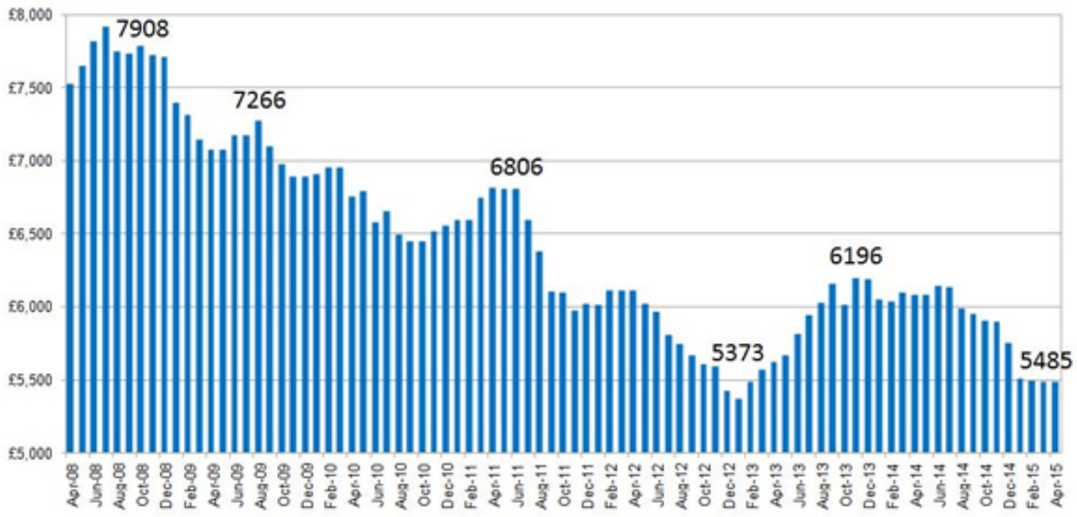
---

[17] Psychological Aspects of Decumulation Decisions: The Case of Tontine Insurance, Suzanne, B Shu, UCLA

The UK

The UK has similar demographic and economic related pension issues as Ireland:

- Increasing longevity.
- Ill-health in later life associated with this increased longevity.
- Declining interest rates making traditional annuities expensive by historical standards. The graph below[18] illustrates how annuity prices have increased since 2008 in the UK. A £100,000 pot would have bought a £7,900 p.a. level single life annuity in 2008 but only £5,485 p.a. in 2015.
- Issue of small pension pots and relatively expensive management costs/fees to service these.



Annuity rates chart for £100,000 fund, aged 65, level and single life

There are, however, also some differences between the UK and Irish markets:

- The UK market is much bigger than the Irish one for annuities. This can mean more efficient pooling of risk and (based upon a greater number of providers) likely more competitive prices in the UK in the open market.
- Inflation is different in the two markets. Annuity returns linked to inflation have not fallen as much as in Ireland.

[18] SharingPensions.co.uk benchmark rates for 65 year old, £100,000 fund in a single life, level annuity with no guarantee period.

- The UK has more control over monetary policy as it is not in the Euro enabling it to adjust (for example, the Bank of England base) interest rates to suit economic conditions. Interest rates are currently somewhat higher than in the Eurozone.
- The annuity market is more developed with widespread use of postcode and Underwritten (or Enhanced) Annuities in the open market offering greater sophistication and accuracy of pricing.

Considering the similarities it may be useful to look at new developments in the UK whilst also allowing for the fact that not all products will be equally suitable due to the differences which exist between the two markets.

Secondary Annuity Market

The UK has recently significantly relaxed the rules governing what people can do with their retirement pots, removing the compulsory purchase of an annuity.

However, these recent changes in the UK allowing more freedom with regard to annuity purchase at retirement will only affect people retiring from April 2015 onwards. Consequently the UK government has also set out an intention, recently deferred to 2017, for a ‘secondary market' allowing annuities already in payment to be sold on. The annuity holder can sell the right to the income that they receive without unwinding the original annuity contract.

Only annuities in the name of the annuity holder and held outside an occupational pension scheme would come within the scope of the proposed new rules. Also annuity providers would be allowed to block sales as the government does not want to "interfere" with existing contractual agreements. Annuity providers will not be allowed to buy back annuities as the government fears they might come under significant public pressure to do so with potential repercussions to their solvency.

Potential problems include the risk that annuity providers will not know when to stop payments to a third party buyer on the annuity holder's death as well as monitoring the charges imposed by annuity providers to ensure that they were not exploiting customers who wished to sell on their annuities.

With regard to future retirees (from April 2015 onwards) the new relaxed legislation combined with the need for new products to better cater for income needs in retirement has led to the development of several new products in the UK. Some of these new products include:

Flexible Income Annuities

New rules allow enhanced flexibility in annuity income to allow for changing income requirements in retirement:

- Higher at start, people spend more on their home, family and holidays.

- Lower later on as stay at home more and income needs fall.
- Higher again towards end due to health or care costs (this is not a contingent payment but a fixed design feature).

This leads to “U” (or even “J”) shaped income requirement where care costs at older ages mean an escalating cost of living as they grow older. These income patterns could not be facilitated with traditional fixed income annuities. (In Ireland, family and State play a strong role in later life care and these may not be as popular).

Products with a care funding option

These are products which offer the option of much higher income, in the event that the person needs later life care. If the person passes the prescribed criteria to classify as needing long term care, for example they become cognitively impaired, then the Long Term Care (LTC) benefit is activated.

These products vary greatly in structure, ranging from annuity like products to more income drawdown orientated products. If the consumer has a qualifying need for long-term care services, some products give access to a monthly benefit for a set number of months or, in some cases, for the remainder of their lives. Other products have a built-in long-term care "multiplier”. This amount is determined by the amount of coverage chosen when the policy is purchased. An example would be where the client deposits €100,000 lump sum in an income drawdown like product which also gives them LTC cover of €300,000 should they need it.

This approach has a number of advantages for the client, including:

- Continued access to funds through the annuity;
- Cost of the LTC coverage is typically less than the premium on a stand-alone LTC policy;
- LTC coverage can be obtained without health underwriting (in some policies);

Care funding is a significant problem looming in the coming decades and using retirement funds to help alleviate the problem could be very beneficial to society in general.

Annuities with investment upsides

Standard annuities do not let the pensioner benefit from investment market returns. These annuities offer some downside protection while also allowing the pensioner upside potential depending on investment return. They are very popular in US and may become more popular in the UK.

Income Drawdown

Income drawdown is a method of withdrawing money from a registered pension scheme. It enables the pensioner to use their funds with greater flexibility and freedom than an annuity.

Flexi-Access Drawdown arrangements is the new name given to drawdown contracts that start after 6 April 2015 in the UK. They offer tax efficient methods to drawdown funds.

For example if a retiree had a DC fund of £200,000 then:

- If they draw it all down in 1 year they pay the higher rate of tax on everything above 20% tax threshold (say £32,000). For example £32,000 @20% and £168,000 @40%=£73,600.
- If they phase withdrawal to minimise income tax then they only pay the 20% tax band each year by limiting their yearly drawdown to a maximum of £32,000. As a result they only pay total income tax of £40,000 (i.e. 20% of the £200k over a number of years) .

While these products allow total flexibility they come with obvious risks:

- Bomb-out risk – running out of funds before death.
- Inappropriate decumulation strategies for individual goals/income requirements.
- High investment management expenses.
- Social risks – Pressure from family to release funds to children etc.
- Investment expertise – Require adequate knowledge of investments in order to prevent mismatch between investment strategy and investment goals.

Different proposals to mitigate some of these risks include:

Bucketing

A potential option may be to divide the retirement pot into two or more buckets. Withdrawals may then be made mechanically in a strict order from these buckets (other forms may offer some discretion).

An example strategy might consist of three buckets as follows:

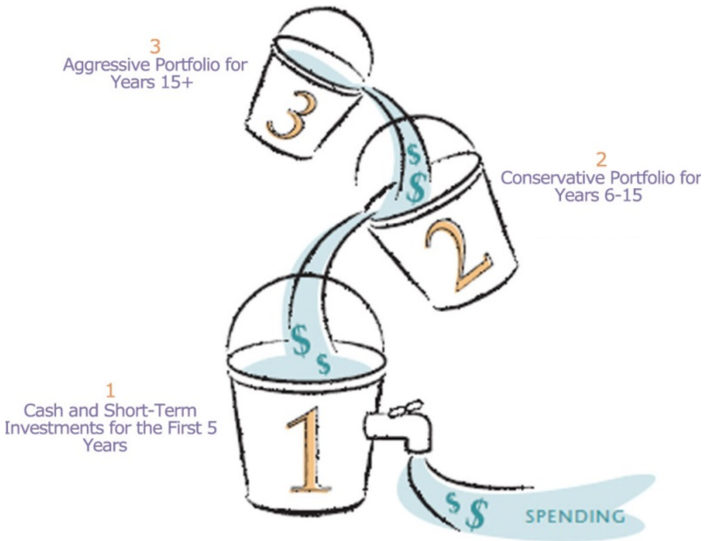
- Cash and Cash equivalent investments – Cover first 5 years
- Fixed income securities – Cover years 6-15
- Equities – Cover years 15+

In this way the least volatile assets are used first thus preventing the pensioner using the inflation linked growth potential equites until later and thus mitigating the short term volatility associated with equities.

As shown below[19] at regular intervals the first bucket will need to draw from the second and the second bucket will draw from the third in order to continue to meet their intended use for

[19] American association of individual investors – Comparing a bucket strategy and a systematic withdrawal strategy

each time period. The balance of each bucket would be checked with regular frequency and depending on market returns redistribution among the buckets might occur to ensure the target balance of each bucket is maintained.



Auto Rebalancing

This essentially means portfolio is continually rebalanced to maintain certain asset split (say 70% equity, 30% bond) even with market movements rather than letting the portfolio asset split vary with the ebb and flow of the market. It has the benefit of maintaining consistency of the consumer's original portfolio design and asset allocation as well as decreasing the risk that due to market movements the portfolio ends up more heavily invested than intended in a certain asset class.

Targeted Volatility Strategies

These are investment strategies that aim to reduce or target a given level of volatility. There might be a range of funds to choose from where each one has a different volatility target. These funds may then use buy and hold strategies or dynamic asset allocation to try and achieve the desired level of volatility in portfolio returns.

Whilst many of these techniques have some merit, even the best of them cannot fully mitigate poor investment returns over a long period impacting the individual's retirement funding.

Summary of UK market

The UK annuity business is going through massive changes with current and future retirees given greater freedom than ever before with regard to how they use their accumulated savings to fund their retirement. Issues such as their desired lifestyle in retirement as well as desire to pass wealth on to family members when they die are but two of a multitude of factors which will influence their decision.

An array of new products ranging from variable annuities and advanced life deferred annuities to income drawdown methods such as bucketing will try to cater to this diverse range of desires and enable everyone to achieve the retirement they want. However, with this dizzying array of new products dangers exist in the form of insufficient consumer education and miss-selling by providers. To date, most of the evidence is that retirees are largely choosing between the standard drawdown product and annuities, with the majority favouring flexibility.

Hopefully through efficient education of the public and regulation of commercial suppliers of these products, the increased freedom should result in more tailored solutions for consumers enabling them to attain their desired lifestyle in retirement. However, it will take many years before the wisdom (or otherwise) of the change becomes apparent.

Australia

Background

With the same demographic issues and concerns about the affordability of future pension payments, like Ireland and the UK, Australia introduced in 1992 a three pillar approach to retirement provision:

- A means-tested state pension
- Private saving through compulsory contributions to a pension (Super Fund)
- Voluntary saving through their pension and other investments.

The minimum employer contribution required under the Super Fund has gradually increased (currently 9.5% of salary) and will reach 12% by 2025.

The Australian market essentially offers 2 post retirement products – Account based pensions (very similar to ARFs) and annuities.

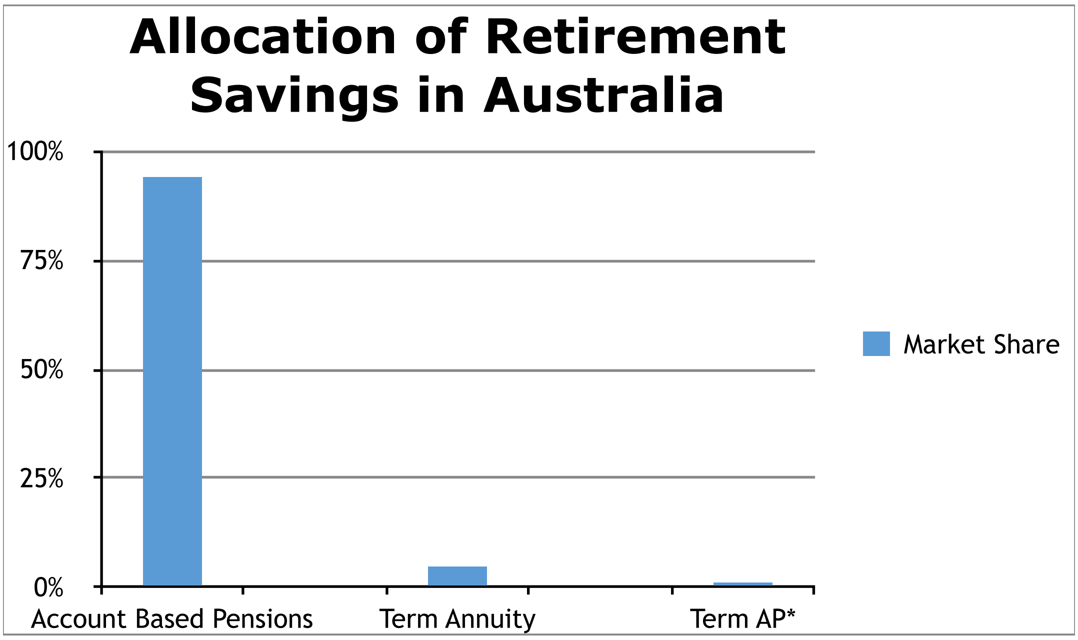
- **Account based pensions** are started with a lump sum from your super fund. The money is transferred from an accumulation account to an account-based pension account, after you reach preservation age. You have to withdraw a minimum amount each year, depending on your age. Below is a table of the amount which can be withdrawn each year. Setting a minimum withdrawal amount by age appears to be a more considered approach than that in Ireland. Any remaining fund on death is passed to the individual's estate.

Age	Annual payment as a % account balance	Age	Annual payment as a % account balance
55-64	4%	85-89	9%
65-74	5%	90-94	11%
75-79	6%	95+	14%
80-84	7%		

Annuities

- **Term annuities** are far more common in the Australian market than life annuities. This appears to be because of the cost of life annuities and the relative flexibility term annuities offer with a term of anywhere from 1-50 years available.

- **Variable annuity** – whilst variable annuities are available in Australia through a number of life insurers, they have made little or no impact in terms of market share. (See below graph of market share data for 2011 to see what pension options Australians typically take out.)



**Source: Centrelink, Plan for Life, APRA, AFTS, Oliver Wyman analysis (2011)*

Summary of Australian market

Australia has been very proactive in its approach to retirement planning. The vast majority of the population choose an account based pension rather than the traditional annuity approach. The risk of funds bombing out before death and fluctuating income are the two main drawbacks with the account based pension. It seems that once annuities become a non-standard choice, they can quickly become very small in overall usage.

USA

Background

The US is similar to Ireland in that there are many different types of retirement plans – DB, DC and various individual retirement account products. The take-up rates have been poor. One estimate states 75% of those nearing retirement had an average retirement fund of approximately $30,000 in 2010.

Below is a list of some of the types of pension accounts/products available in the US. Some are designed with both the accumulation (deferral) and withdrawal phase in mind.

- An **Individual Retirement Account (IRA)** is a tax–advantaged retirement account that you own and control both pre and post-retirement. There is a maximum annual contribution allowable but once in your 50s you can catch-up on contributions. Tax is payable on withdrawals. Withdrawals prior to age 59.5 may be subject to a 10% federal tax. There is no penalty thereafter and withdrawals must begin by age 70.5. The minimum distribution is determined by dividing the prior year–end fair market value of the retirement account by the applicable distribution period or life expectancy. This promotes sensible behaviour in retirement by imposing an appropriate considered withdrawal amount.
- **Immediate annuities** offer guaranteed income for life or a set period of time.
- **A (deferred) fixed annuity,** which can provide a guaranteed pay-out either for the annuitant's life or for a defined length of time. Premiums can be paid in a lump sum or in instalments.
- **Deferred income annuities** are fixed income annuities that have a deferral period before income payments start. A cost-of-living increase can be selected.
- **Immediate variable income annuities** offer an immediate income stream with growth potential, which may help keep pace with inflation. This income is guaranteed for life, but the amount of each income payment is not guaranteed—the payment amount will vary based on the performance of the annuity's underlying investments.
- Some deferred variable annuities provide both **guaranteed lifetime income and growth potential,** and may offer access to assets as well. If the account's investments perform well, the income payments may increase. Those increases are also protected from any later market declines.
- Another type of **deferred variable annuity** benefit is one that protects your savings from market downturns while still allowing you to participate in the market's potential upside. These types of accumulation annuities provide a minimum downside

protection, for example, your initial investment amount, while investing in a diversified portfolio that includes equities for portfolio growth over time.

The main concern with variable annuities is the level of expenses. Typically management fees are in the region of 2-3% per annum but can be higher when commission is included.

Summary of US market

The US offers a wider range of products to try to better meet individual needs during retirement. The risk of funds bombing out before death and fluctuating income are the two main risks which these range of products try to address. These solutions have tended to come with higher charges which in themselves represent a barrier to sales.

Chile

Chile is unusual in that is has a fully voluntary system but very high annuity take up rates. A recent article by US Economist Milevsky ("Solving Chile's Annuity Puzzle" ThinkAdvisor.com) highlights this:

> *"**Commissions**. When independent retirement advisers—those who stand between the retiree and their decision—offer guidance, it is commission neutral, unlike how things work on this side of the equator. In other words, the compensation to the independent Chilean retirement adviser isn't affected by whether they suggest a life annuity, a mutual fund or any combination. (Alas, when the Chilean retirement adviser is an employee of a mutual fund company, the annuitization rate is lower. Surprise!)*
>
> ***Illustrations**. All retirees are shown (mandated, regulated) illustrations that suggest a volatile and possibly declining income stream if they go with the SWiP* [Systematic Withdrawal Plan]*, and if long-term investment assumptions are not met. In other words, they have a better understanding of the risk.*
>
> ***Inflation**. All life annuities sold in Chile are indexed to inflation, or more precisely to unidades de fomento (UF)* [Chilean unit of account] *as opposed to nominal pesos. So, there is no inflation risk to the annuitant, thus making it a more secure source of real lifetime income. In the U.S. most life annuities are nominal, and the few real ones are real expensive too.*
>
> ***Lack of pensions**. Remember that for most Chileans this individual account is all the retirement money they have. There is no other defined-benefit corporate or government pension plan, which would backstop their retirement spending. They have no other form of longevity insurance other than the life annuity.*
>
> ***Perceived safety.** The Chilean government explicitly backs or guarantees insurance company payments (up to a limit) in the event of insolvency or bankruptcy. This is different from the U.S. system, which is a mutual arrangement between companies, and overseen by the individual states. Perhaps it even feels like Social Security."*

We feel the lack of a State pension has a key role to play here. People have no baseline guaranteed income so play safe. We also feel the herd instinct is working here in favour of annuities in the way it's working in the other direction in countries like Australia.

Conclusions

The key recommendations of the post retirement modelling report are as follows:

- The Working Party would encourage a view that both annuities and ARFs play a role in the post retirement portfolio of all clients. Diversification should extend to product types as well as funds within a product with a varying portion of annuity/ARF appropriate by individual. Furthermore, care should be taken before clients are prompted one way or the other based upon current market conditions (particularly “low interest rates”) as these are notoriously hard to call and “unusual conditions” can last for decades.
- We feel the purpose of retirement saving in Ireland has become, for some, too focussed on capital preservation and the inter-generational wealth transfer rather than provisional of high quality of life in retirement. An important driving force for a number of post-retirement decisions seems to be passing the funds to the next generation (and for some wealthier people in a tax efficient manner). We feel for average earners the focus on giving the retiree the best quality of life and stable income should be more centre stage than passing funds to the next generation. Other than for wealthy individuals whose assets clearly exceed their requirements, any bequest should be a happy side product rather than the primary purpose of retirement funding.
- Greater modelling of longevity and bomb-out risk amongst advisers should be encouraged. Advisors in this area should be able to provide illustrations of the likely variation of outcomes for people under different returns and longevity scenarios. A real challenge here is the provision of on-going advice throughout retirement. This is as critical for ARF holders as advice at retirement. For smaller funds there is a challenge in the need to pay for this out of charges (either as trail commission or advice fees, neither of which are popular or, perhaps, valued here in Ireland). Whilst some product initiatives (under D) may help this, it will not remove the problem. The exact responsibility of adviser and providers here is unclear. Larger funds tend to get better service and advice. However, we feel there is a risk that small and medium sized ARF holders are just not getting adequate on-going advice.
- Providers should give consideration to the feasibility of a number of new products variations:
    - deferred annuities vesting at older ages as a protection against longevity- these would be pure annuities starting at (say) age 75 or 80 that provide a backstop to declined funds or poorer health

  - post retirement life-styling whereby ARFs can gradually de-risk over time into more appropriate low risk cash and bond funds (or even auto roll-over to annuities)

- The Working Party would encourage Revenue and providers to co-operate more actively to develop regulations which would allow greater flexibility in annuity products (including an ability to make a once-off advanced draw-down of a year's income, ability to have some element of life assurance as a standard product option or increased guarantee period out to 20 years)
- The Working Party assessed some of the ideas elsewhere which we found were not particularly promising. The Australian proposed Group Annuity pooled longevity concept is very interesting in theory but we felt it would have many practical challenges (amongst them the required level of discretion, and lack of contract certainty).

ARF v Annuity Comparison

This simple comparison looks at the relative advantages of the products under each heading. The consumer here is assumed to be an average person who consequently is likely to have limited financial knowledge and will be somewhat risk averse. We have added in a sample Variable Annuity contact typical of those currently sold in the UK.

	ARF	Annuity	Sample Variable Annuity Product
Certainty	Significant uncertainty – longevity, investment and charging all result in uncertainty of income.	Perfect certainty – retiree knows exactly what they will receive each year they are alive.	Imperfect certainty – retiree knows the minimum they will receive each year they are alive.
Flexibility	Very flexible in terms of investment choices, drawdown, QFM and can even convert to annuity at later stage.	None – decision made at point of retirement must be “lived with”.	Decisions must be made at retirement regarding deferring income and leaving a benefit to your estate on death.
Investment Risk	Significant - onus on retiree / adviser to pick funds to maintain fund and standard of living. Potential to generate higher income with good investment returns.	None for the retiree.	Income guaranteed for life - can benefit from positive investment performance with a lock-in feature. The maximum fund value is recorded each month and the maximum fund value is locked-in if the observed fund value exceeds the previous high.
Growth potential	Opportunity to achieve returns gives the chance to grow initial fund and increase drawdown potential.	None	There is some growth potential. The fund value is observed each month (12 times a year) and the highest value is locked in at the start of the following year. However, charges are high and will restrict any growth. Fund selection appears to be quite limited.

ARF v Annuity Comparison

	ARF	Annuity	Sample Variable Annuity Product
Inflation risk	Will depend on investment choices – if investing in real assets, inflation risk should be greatly reduced.	Significant – higher than expected inflation will greatly reduce purchasing power. Inflation-linked annuities may be expensive and / or undershoot actual inflation*	Likely to be significant but will depend on the fund performance and whether the lock-in value is a good hedge for inflation.
Bomb-out risk	Potentially significant given drawdown requirements, poor investment performance and high fund charges	None for the retiree.	None for the retiree if they withdraw the initial amount throughout.
Inheritance Options	Good options available – ARF on death can be passed to spouse / children in tax-efficient manner.	Limited – spouse / dependent's and guarantee period pension can be added at point of purchase but reduces initial annuity payments. Payments cease on death.	Guaranteed death benefit can be chosen at the start (with a cost).
Tax	Tax paid on drawdown from fund.	Tax paid on annuity payments.	Tax paid on income payments
Sub-standard lives	May be best option given inheritance options.	Enhanced annuities have improved the annuity offering here but still lags behind for those who are significant health risks.	Similar to the ARF given the inheritance option.
Ongoing management	Significant overhead – need to choose investment mix and drawdown carefully, will likely need ongoing advice, which will need to be paid for.	None for the retiree.	Significant overhead - investment fund chosen at the outset. Investment performance may be reviewed with an adviser.

ARF v Annuity Comparison

	ARF	Annuity	Sample Variable Annuity Product
Value for Money	Depends on quality of ongoing advice – does it produce returns in excess of cost of advice and ahead of implicit annuity returns?	Perceived as poor value but reflects returns in the markets and estimated average longevity. Removal of investment and longevity risk from retiree has significant value for money.	Guaranteed income at the outset most likely less than an annuity. Difficult to judge the value of the lock-in feature.
Peace of mind	Depends whether retiree is comfortable with the risk level being taken on investment and longevity.	Certainty brings peace of mind but the opportunity cost of that certainty could be significant.	Certainty brings peace of mind but the opportunity cost of that certainty could be significant.
Complexity	Challenge/requirement to continually review appetite for risk and understanding investments, charges and regulatory requirements. Ability to understand and capacity for decision making may reduce with age.	Need to understand escalation, guarantee period, spouse's death at point of retirement but nothing thereafter.	Scores very low (negative?): Complex as to how the lock-in feature works and the impact of the investment choice at the outset. Difficult to compare with an ARF in terms of value.
Psychological	Client can see and relate to their wealth more easily with a tangible investment in an ARF available to them – annual statements etc. No perceived loss at hand over of assets.	Difficult to assess the value of the future income stream. Perceived loss of handing over a large lump sum from their "Account" to insurer.	Client can see and relate to their wealth more easily with an attributable fund value – annual statements etc. However, this can be realised only on death.
Fiscal Regime	Subject to variations in deemed disposal regime, inheritance tax etc. into future which may or may not suit. More exposed to new regulation?	Possibly less exposed to future changes?	Subject to income tax and inheritance tax rule changes.

ARF v Annuity Comparison

	ARF	Annuity	Sample Variable Annuity Product
Regulation	May not be subject to Life Regulations at point of sale. On-going relationship with advisers. Oversight of underlying investments.	Subject to the Life Regulations and CPC at point of sale	Subject to the Life Regulations (?) and CPC at point of sale. On-going relationship with Advisers with regard to investment performance.
Counterparty Risk	Exposed to security risks with some non-insurance company based ARFs. Potential additional risks with any underlying investment quality and security.	Greater security offered by insurance company and Solvency II. Generally secure.	As for annuity. Greater security offered by insurance company and Solvency II. Generally secure.
Tax Efficiency	Ability to take a flexible income (after covering the deemed drawdown) to manage income tax liability in co-ordination with other income/ assets	Fixed income with little flexibility to manage income received in co-ordination with other income/assets.	Fixed income with little flexibility to manage income received in co-ordination with other income/assets.
Confidence	There may be an over confidence with individuals in their ability to manage significant sums of money over the medium to long term.	There may be a fear or insecurity at point of retirement leading to an aversion to engage in a meaningful analysis of retirement planning i.e. no appetite for engagement and client just wants to get their pension and be done with it. No desire to spend time on the best decision for them or commit to future engagement.	There may be an over confidence with individuals in their ability to manage significant sums of money over the medium to long term.
Timing Risk	Have the flexibility to make investment decision based on market conditions.	No flexibility as annuity decision made at a point in time.	Limited flexibility with investment choices

**data from one major life office suggests purchase of any form of escalation from DC funds is well below 5% (only a portion of this would be actually CPI linked).*

Where the client is more risk accepting and/or financially experienced, the result will differ somewhat with the downsides risks not as critical.

The ability to leave an inheritance could compensate for a potentially lower starting guaranteed income compared with that of an annuity. The actual value of the lock-in feature is difficult to assess. The likelihood that the income in time will exceed that of the annuity depends on the pattern of investment returns (net of annual management charges) versus withdrawals.

In practice we would suggest that the choice depends largely on the individual retiree and hence the importance of good financial advice both at point of retirement and on an on-going basis.

Recommendations

The following is a list of recommendations by the Working Party emanating from the above analysis.

Recast ARF option

1. ARF option to be provided to all DC retirement funds, including Buy-Out Bonds funded by transfers from DB schemes.
2. Option to allow a mix of transfer to ARF, taxable cash, and/or purchase of annuity (immediate and/or deferred with a maximum deferral age of 80), after taking a lump sum (max 25%).
3. Where remaining funds after taking the 25% lump sum are less than €20,000 allow taxable cash option (in addition to annuity option); the €20,000 limit would be a personal lifetime limit linked to the Revenue practice limit on full commutation.
4. The current €12,700 pa specified income and €63,500 annuity purchase options to get to the ARF or taxable cash options would be abolished, and be replaced with a requirement to invest up to €200,000 in a revised AMRF structure (or possibly as a differentiated part of an ARF called the restricted zone (RZ)) for all new retirees.

   The AMRF requirement at the point of taking benefits would be reduced by:

   - The capital equivalent of any private defined benefit pensions (i.e. excluding the State Pension) the retiree is then in receipt of; the capital value being calculated using the current capital factors used to value pensions for the purposes of the Threshold Limit system.
   - Any retirement funds previously used to purchase an annuity (of a specified type) payable to the retiree.

   The ongoing AMRF requirement would be reduced in the future by:

   - The capital equivalent of any private defined benefit pensions (i.e. excluding the State Pension) the retiree becomes entitled to in the future;
   - The value of any retirement funds used in the future to purchase an annuity (of a specified type) payable to the retiree;
5. Revised AMRF structure (or the restricted zone of an ARF where both the AMRF and ARF parts could be held within the same account/product):

   - AMRF automatically converts to an ARF on the earlier of death or reaching age 80.
   - Optional AMRF drawdown of up to 5% pa; no imputed distribution.

- AMRF drawdown rate option is deemed to commence at age 60 regardless of the age at which the AMRF is established. Any year's unused drawdown rate in a year from age 60 can be carried forward until utilised.

  E.g. A retiree opens a new style AMRF at age 64. In the first year he or she is entitled to withdraw up to 5% for the current year plus 4 x 5% for the four previous years since 60, i.e. up to 25%.

The revised AMRF drawdown provides greater flexibility income up to age 80, compared to the present use it or lose it 4% pa withdrawal. It also incentivises later commencement of AMRF withdrawals by allowing higher once off withdrawals the longer drawdown is postponed or not taken fully.

6. Funds could be withdrawn at any time from the AMRF/ARF to purchase an annuity of a specified type payable to the AMRF/ARF holder without the withdrawal being considered a distribution for tax purposes. The annuity would be liable to taxes in the normal manner.
7. The potential to allow the ARF / AMRF option either within a DC scheme or with a Group ARF / AMRF trust structure should be investigated further.
8. Remove the vested PRSA option for new retirees to streamline the system and reduce complexity.
9. The lump sum option under DC occupational pension schemes be amended to the greater of:
   - The maximum lump sum on the Revenue uplifted scale (related to service and final remuneration), and
   - 25% of the DC fund.

   This would in effect abolish the current traditional benefit option under DC schemes and ensure that the choice of lump sum taken would have no impact on the choice of options taken for the balance of the fund. Currently if a lump sum is taken on the Revenue uplifted scale (related to service and final remuneration) the balance of the DC fund must be used to buy an annuity. As many current DC retirees are lowly funded, they effectively have to buy an annuity to get the best tax free lump sum on offer. We don’t believe there was ever a desire to push members one way or the other (on annuity v ARF) via indirect lump sum differences.
10. At a minimum, the current precipice design of the 4%/5% withdrawal rate increasing to 6% when funds exceed €2m be abolished; there is no actuarial basis for a higher withdrawal rate based solely on fund size.

Recommendations

Advice regulation and best practice

1. The provision of advice on a professional basis on generic ARF v annuity v cash options, be made a regulated activity subject to associated Central Bank conduct of business rules.
2. Require a regular review of AMRFs and ARFs (no less frequently than every 3 years) and report in writing to the AMRF/ARF holder on:
    - The immediate lifetime annuity which could then be secured by the full fund based on open market annuity rates at the date of the review.
    - the sustainability of future income withdrawals from the AMRF/ARF at:
        - i. the annual amount (excluding ad hoc withdrawals) last withdrawn in the year ending on the date of the review
        - ii. the immediate lifetime annual annuity which could be secured by the fund at the date of the review.
    - remaining average expectation of life.
3. Provide a simple accessible Power of Attorney facility for AMRF and ARF holders.
4. All ARFs and AMRFs provide mandatory health warnings regarding suitability of fund choice, lack of capital guarantee, lack of inflation protection, fund volatility etc.

Product developments

1. Providers should give consideration to the feasibility of a number of new products variations:
    - deferred annuities vesting at older ages as a protection against longevity- these would be pure annuities starting at (say) age 75 or 80 that provide a backstop to declined funds or poorer health
    - post retirement life-styling whereby ARFs can gradually de-risk over time into more appropriate low risk cash and bond funds (or even auto roll-over to annuities)
2. Revenue and providers to co-operate more actively to develop regulations which would allow greater flexibility in annuity products (including an ability to make a once-off advanced draw-down of a years' income, ability to have some element of life assurance as a standard product option or increased guarantee period out to 20 years)
3. The Working Party suggest:

- o the development of longevity tools which could be made available to the public to show remaining expectation of life estimates (including joint life last survivor where an AMRF/ARF will provide a retirement income for two people) in a manner which is understandable to the consumer and doesn't assume a high knowledge of probability.
- o Liaising with the Central Bank on conduct of business requirements that might be applied to the provision of advice on generic retirement benefits options and throughout retirement where the retiree chooses the ARF option.
- o Partnering with educational bodies which provide professional qualifications meeting the Minimum Competency Requirements for financial advisers, in the development of 'at' and 'in' retirement financial planning tools, e.g. future projections of income and expenditure with survival probabilities, to enhance the quality of advice provided at and during retirement to retirees who opt for the ARF option.
- o Conducting further research on:
  - The ARF imputed distribution rates and their impact on income survivability, given that the vast majority of ARF holders withdraw at the imputed distribution rate;
  - Appropriate investment allocations for AMRF and ARF holders in the context of income sustainability and possible future annuitisation of the AMRF/ARF (e.g. where annuity purchase is deferred rather than rejected outright).

4. The Working Party believes that the following would result from the analysis conducted and recommendations made in this Review:
   - o The establishment of a more subtle post retirement approach incorporating a balanced portfolio with ARF and Annuity playing complementary roles rather than the present either/or scenario.
   - o Greater awareness and modelling of longevity risk not just at retirement but throughout retirement if a drawdown is used.
   - o The purpose of retirement saving (in giving the retiree the best quality of life and stable income) being more centre stage rather than tax efficient inheritance planning.
   - o Encouraging greater awareness of the psychology of the post-retirement choice, to ensure that retirees and those in the run up to retirement are advised in making decisions which maximise the quality of their retirement lifestyle.

Members of the Working Party.

Alan Hardie (Chair), Tony Gilhawley (Deputy Chair), Shane O'Farrell (Deputy Chair),

Gerard Barry, Fergus Collis, Fred Gilmore, Brian Grimes, John Groarke, Darragh Kirwan, Martin McGovern.