# Society of Actuaries in Ireland
## Position Paper on Defined Contribution Plans & PRSAs

### Background

There are two main types of pension plan in Ireland. Defined Benefit (DB) plans provide a pension that is defined in relation to salary and service. The individual member's contributions, if any, are typically at a fixed rate and their employer will contribute at a variable rate in order to meet the balance of the cost of providing the individual's benefits.

Defined Contribution (DC) plans do not guarantee a level of pension. Instead, both the individual and employer pay a fixed rate of contribution. These contributions, along with investment returns, accumulate in a fund that is eventually used to provide pension benefits at retirement.

The certainty of a fixed contribution rate is a huge advantage of DC plans in employers' eyes and has made them the fastest growing type of retirement provision in Ireland. PRSAs, which will be launched early in 2003, are essentially personal DC plans. In addition, some employers are closing their DB plans and opening DC plans in their place.

The increasing importance of DC plans means that it is important that careful consideration should be given to the likely benefits that members can expect from them.

### Contribution Rates

The pension that an individual will get from a DC plan depends on many factors including the age they start saving, the age they retire, how much they and their employer contribute, investment returns, administration and investment charges and the cost of buying a pension at retirement.

Of these factors the one that individuals and scheme sponsors have most under their control is the level of contributions. The Society of Actuaries in Ireland is concerned that in many instances contribution levels are inadequate as:

- In many DC plans contributions do not reflect the individual's own circumstances.

- Many new DC plans are established with contribution rates lower than the DB schemes they replace.

- The prospect of lower investment returns in the future means that the rate of contribution needed to fund an adequate pension has increased.

- Life expectancy in retirement is increasing rapidly and this will also increase the cost of buying a pension for future retirements.

- Falling interest rates have made it more expensive to purchase a pension at retirement.

**What level of income should individuals target at retirement?**

Individuals need to consider what their income needs will be in their retirement. Some expenses, such as costs relating to mortgages and travel may be reduced, while others, such as medical expenses, may increase. On its own, the State pension falls well short of providing the standard of living enjoyed by most people who are approaching retirement age.

The Pensions Board in its 1998 report "Securing Retirement Income" suggested that a target level of post retirement income of 50% of gross pre-retirement income (including the Social Welfare pension payable to a single person) was a minimum adequacy level. This is a basic level of income - for example, a person on the average industrial earnings of €497 a week would have an income in retirement before tax of €248 a week. We have also considered a more generous level of post-retirement income of 67% of gross pre-retirement income.

**What contributions should be made to DC plans?**

Below we show recommended pension contribution rates, as a percentage of salary, for an individual starting to save in a DC plan. The costs of any life assurance or disability cover (permanent health insurance / income protection) would be additional to these figures.

As actual future events will vary from that assumed, individuals should get regular reviews of the expected benefits provided under their DC plan to ensure they are still on target to provide their desired level of benefits. The Society welcomes the requirement for PRSA providers to give regular benefit projections to contributors, and believes that this should be extended to all DC plans.

In these tables we are assuming entitlement to a full Old Age (Contributory) Pension payable to a single person (currently €157 a week).

**Estimated contribution rates required to target a post retirement income of 50% of pre retirement income at age 65 for differing starting ages**

| *Annual Salary* | *Target Pension in today's money* | *25 year old* | *30 year old* | *35 year old* | *40 year old* | *45 year old* |
|---|---|---|---|---|---|---|
| €20,000 | €10,000 | 3% | 4% | 5% | 6% | 8% |
| €25,867* | €12,934 | 7% | 8% | 10% | 12% | 16% |
| €30,000 | €15,000 | 8% | 10% | 12% | 15% | 20% |
| €40,000 | €20,000 | 11% | 13% | 16% | 20% | 26% |
| €50,000 | €25,000 | 12% | 15% | 18% | 23% | 30% |

**Estimated contribution rates required to target a post retirement income of 67% of pre retirement income at age 65 for differing starting ages**

| *Annual Salary* | *Target Pension in today's money* | *25 year old* | *30 year old* | *35 year old* | *40 year old* | *45 year old* |
|---|---|---|---|---|---|---|
| €20,000 | €13,333 | 9% | 11% | 14% | 17% | 23% |
| €25,867* | €17,245 | 13% | 15% | 19% | 24% | 31% |
| €30,000 | €20,000 | 14% | 17% | 21% | 27% | 35% |
| €40,000 | €26,667 | 17% | 20% | 25% | 31% | 41% |
| €50,000 | €33,333 | 18% | 22% | 27% | 34% | 45% |

*  An annual salary of €25,867 is equivalent to the average industrial wage i.e. €497 a week. (as at December 2002).

For the lower salary levels shown, the recommended contribution rates are lower. This is because the state Old Age pension provides a greater proportion of the target pension, and therefore the proportion to be privately funded is smaller.

These figures relate to retirement at age 65. Funding for retirement at an earlier age would require higher contributions.

**Existing contribution rates**

The recent survey carried out by the Irish Association of Pension Funds (IAPF) showed that on average contributions to Defined Contribution plans (excluding the cost of insuring death in service benefits) were approximately 10% of salary.

This means that based on the calculations outlined above, most members will not even have sufficient funds at retirement to provide them with a pension of 50% of pre-retirement income unless they start to make additional contributions, or unless future experience turns out to be better than expected.

**Uncertainty**

Another major source of concern is the lack of certainty associated with DC pension plans. Individuals face the risk that they may retire at a time when equity markets have fallen and interest rates have fallen.  This means that they may face a double hit of a lower fund at retirement and a higher cost of purchasing a pension.

For example between 1 January 2002 and 1 January 2003 the value of an investment in a typical Irish Pension plan has fallen by approximately 19%.  Over the same period the cost of purchasing a pension has risen by approximately 3.5%.

As a result many individuals' expected pension benefits have fallen substantially. Even though what has happened over this period is highly unusual, it does serve to emphasise the uncertainty underlying DC pension plans.

**Conclusion**

DC plans are an important part of private pension provision in Ireland.  PRSAs are effectively individual DC arrangements, and should increase to some degree the number of people making provision for their own retirement.  But unless sufficient contributions are made, these plans will leave individuals' retirement ambitions unfulfilled.

In many cases individuals are insufficiently aware of the amounts needed to save in order to provide an adequate level of income in retirement.  Unless individuals plan adequately for retirement, there is a strong risk that they will face a substantial fall in their level of income at a time when they do not have a chance to replace that income.  Individuals should seek professional advice on their own particular circumstances.

**Note on Assumptions used in calculation of contribution rates**

The economic and demographic assumptions used are in line with the Society's Guidance Note GN31A on projections for PRSAs. This includes an allowance for future improvements in mortality rates.

The pension being funded is payable for life. On death a spouses pension of 50% of the main pension is payable to a surviving spouse. Both pensions are assumed to increase by 3% per annum.

The contribution rates shown are the average for males and females. Contribution rates for males are slightly lower than those shown while contributions rates for females are slightly higher.

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