# Defined Contribution Member Options – Annuities and Approved Retirement Funds

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***Summary***

This paper addresses the issue of how some individuals who accumulate retirement funds throughout their working lives on a defined contribution (DC) basis are restricted in how they can use those funds when they reach retirement age. This issue has been highlighted by the Irish Association of Pension Funds (IAPF), among others, in the past as lacking in logic and being particularly unfair on a specific group of individuals, i.e. PAYE workers who are members of DC arrangements.

These individuals carry investment risk throughout their careers but are then restricted to purchasing an annuity when they come to retirement. By purchasing an annuity the individual is forced to lock into a low risk/low return investment for the remainder of their lifetime, which on current projections will be for over 20 years.

This restriction only applies to DC PAYE workers and does not apply to self-employed individuals, proprietary directors or individuals who save for retirement through Personal Retirement Savings Accounts (PRSAs). These also carry the investment risk in their accumulation of retirement funds but are allowed to carry on that form of investment in retirement, if they choose to do so, by transferring to an Approved Retirement Fund (ARF).

This paper sets out the reasons why we believe this option should be available to all individuals who accumulate retirement funds on a DC basis:

- Extending the ARF option to DC members creates a level playing field and it is logical and reasonable to do so as they carry investment risk throughout their careers and should be free to continue to do so, if they wish and where appropriate, in retirement

- This option is not appropriate for DB members as they do not have to carry the same risk in accumulating their retirement benefits. Furthermore they accumulate a benefit and not a fund which is fundamentally different

- Any concerns relating to individuals not properly managing their ARF can be dealt with by appropriate regulation and by strengthening the protection measures currently in place

- Allowing the option to avail of an ARF removes the timing risks associated with compulsory annuitisation and therefore reduces a risk that only applies to DC members

- Transferring to an ARF allows individuals the opportunity to achieve higher returns on their funds in retirement

- Where higher returns are achieved there should be an increase in the overall tax collected on retirement income. Any taxation issues that exist on ARFs should be dealt with by taxation measures and not by exclusion

- The ARF option facilitates those who wish to defer or phase their retirement from the workforce

- It removes the concern that DC members have of losing their accumulated savings to the annuity provider should they die shortly after commencement of the annuity

The conclusions reached in this paper are similar to those reached in the Review of the Irish Annuities Market Report for the Pensions Partnership Review Group prepared by Indecon and Life Strategies. In particular we note some of the points made in relation to annuities:

“Demand arises primarily from defined contribution occupational pension scheme members who have no other option but to buy an annuity”

“We are however concerned about a market where few consumers appear to choose the particular product the absence of legislative obligation to do so in order to secure a tax subsidy”

“However, now that the ARF option has been further extended (including to all PRSA holders), we see no logical reason why retiring members of defined contribution schemes should be subject to different rules in this regard”

***Background***

Retirement provision involves the accumulation of assets during an individual’s working lifetime in order to provide income during the individual’s retirement. In Ireland, as is common in many countries, the State provides incentives for the individual to accumulate those savings. This is provided by allowing tax relief on employee contributions to pension arrangements. Employers also play a large role in contributing towards the retirement savings of their employees. Their contributions are allowable as a business expense and employees are not subject to benefit in kind tax on those contributions. The investment income of pension arrangements is not subject to tax. The State taxes the income that the individual receives in retirement and therefore the tax incentive provided on the initial savings is a form of deferred tax.

Traditionally, retirement provision was relatively straightforward in that assets were accumulated through a combination of individuals’ and employers’ contributions paid during the individuals working lifetime to a pension scheme established by the employer.

These contributions were invested with a life assurance company who managed the assets with a view to achieving a reasonable rate of return on the assets.

### ***Defined Benefit Provision***

Where the pension scheme operates on a defined benefit (DB) basis, each individual member accrues a benefit entitlement, usually based on the member's length of service and final salary. At retirement, the member has the option to surrender some of the benefit for a tax-free lump sum. The remaining benefit is paid as a pension. For all but the largest of schemes, this was normally done by the trustees purchasing an annuity from a life office. The life office then assumed the responsibility of paying the pension amount for the remainder of the individual's life. This was purchased using the general funds of the scheme, as in DB schemes it is a benefit rather than a fund that is accumulated for the individual member. The largest of schemes would pay pensions directly from the fund as they had a sufficient number of pensioners to ensure that the financial risk to the scheme of individual members living longer than expected was not disproportionate and would in all likelihood be balanced by members who would have a shorter than predicted life.

### ***Defined Contribution Provision***

Where the pension scheme operates on a DC basis, a fund is accumulated for the individual member from the contributions paid by the member and the employer, combined with the investment return achieved on those. Effectively each member accumulates an individual pot of money. At retirement the individual member has the option to take some of their fund as a tax-free lump sum and the balance of the assets would be used to purchase an annuity paid by a life office. Self-employed individuals save for their retirement in the same way through an individual contract with a life office.

### ***Changing Environment***

In more recent times retirement provision has become more complicated with more choices available both in terms of how to accumulate savings and the means of providing the income in retirement. This has inevitably created anomalies and inequities and this paper examines one of these.

In terms of the means of accumulating retirement savings the traditional employer established pension scheme still exists. While many pension schemes invest with life assurance companies there are also other options available. Larger schemes, in particular, invest directly with investment management firms. Many smaller schemes also invest directly, particularly schemes for company directors that largely invest in property (and can borrow through the scheme to do so). Individuals can now also provide for their retirement through PRSAs. These are individual contracts between an individual and the PRSA provider. Employers can contribute but most PRSAs that have been sold do not have an employer contribution.

***Annuities***

There has been a significant increase in the cost of annuities. The main reasons for this increase are that people are living longer and interest rates have been at historically low levels. Furthermore the replacement of the Irish pound with the Euro means it is likely that these low levels of interest will persist for the foreseeable future. There are other issues particular to Ireland, especially as the number of companies providing annuities is limited and this has the potential to make the market inefficient.

The fact that people are living longer is a very welcome development but it does mean that individuals have to fund for a longer retirement. Figures from the Society of Actuaries in Ireland show that, in 1980 a typical 65 year old male pensioner could expect to live for another 14.6 years. Today, a typical 65 year old male pensioner could expect to live for another 20.2 years.

However because of this increase in life expectancy and the effect of low interest rates, to provide that pensioner with an annuity of €1,000 per annum in 1980 would have cost €8,330. In 2007, the same annuity would have cost €24,500.

***Effect on DB benefits***

This substantial increase and the uncertain future direction of some of the drivers of the increase has resulted in DB schemes paying pensions direct from the scheme funds rather than purchasing an annuity. In particular there is no consensus on the future level of improvement in life expectancy and there is a body of opinion that insurers are overestimating this when pricing annuities. Insurers argue that they have to be prudent as they have a one-off opportunity to price a contract that could last in excess of 20 years.

Interest rates have been consistently low in recent years. This has the effect of increasing annuity prices as life offices are effectively required by regulations relating to solvency to match their annuity liabilities with bonds which largely track interest rates. Therefore any trustees who believe interest rates will rise may choose to defer purchasing an annuity until this happens and impacts on annuity prices.

There are other factors that add to the cost of annuities such as solvency requirements, administrative costs and profit margins. Many trustees view these as being disproportionate to the overall cost of an annuity. The recent Review of the Irish Annuities Market by Indecon and Life Strategies estimates that for a male aged 65 the annuity cost is 18% more than the cost assumed by a pension fund and 21% more for a 65 year old female.

Furthermore, schemes may be able to ascertain from their own data if they have particular life expectancy patterns that may differ from those of the general population. Where that is the case, and if life expectancy of their members is less than the general population, it may make better financial sense to pay pensions directly from the scheme

funds as the pension is likely to be paid for a shorter period than that which an annuity provider would assume.

This has no direct effect on the benefits a member will receive from a DB scheme as it is the member's benefit that is defined and the cost accrues to the overall fund. Obviously, the greater the cost to the fund the greater the resultant strain on the fund. This increase in costs had led to scheme sponsors considering the sustainability of schemes and in many cases to the closing of schemes to new entrants or even to the winding up of schemes. Furthermore, schemes have to value their pensions in payment on the basis of what it would cost to purchase equivalent annuities in the marketplace when calculating whether or not the scheme meets the funding standard. Therefore, schemes that take the view that it makes more financial sense to pay pensions directly from the scheme funds may still have to set aside the difference in the cost to them and the cost of buying annuities in order to satisfy the funding standard.

***Effect on DC Benefits***

However, the increase in the cost of annuities has a direct impact on the benefits of DC members. Individuals need to have accumulated significantly more in savings in order to buy the same annuity. Using the example above an individual would have needed to have accumulated €8,330 in 1980 to buy an annuity of €1,000 per annum. However, in 2007 the same individual would have needed to have accumulated €24,500 to buy an annuity of €1,000 per annum. Therefore the individual would need to have been saving almost 3 times as much in order to achieve the same result. As there has been no discernable increase in the contribution levels in DC arrangements the increase in annuity rates will have a severe impact on the income of DC members in their retirement. Indeed as individuals tend to now enter the workforce later and retire earlier than in 1980 the time over which individuals can accumulate their retirement savings has also shortened.

***Approved Retirement Funds***

The Finance Act, 1999 introduced a provision which allowed certain groups of individuals to transfer their accumulated funds at retirement to an ARF, once certain conditions are met. This effectively means that many categories of individuals can choose to continue to invest their accumulated funds and not to purchase an annuity at retirement age and draw down on those as and when they need to. This gives much more flexibility to those individuals especially when annuity rates are high at the point of retirement.

Originally this option was available to holders of Retirement Annuity Contracts, members of Retirement Annuity Trust Schemes (which are contract for self-employed individuals), Proprietary Directors and individuals entitled to rights from Additional Voluntary Contribution (AVC) arrangements. It was also made available to individuals who saved for retirement using PRSAs, when they came into being. This allows individuals who have taken investment risk throughout their working lives to have investment choice at the point of retirement.

In any case, a sizeable proportion of people with accumulated pension savings did not now need to purchase an annuity and could continue to invest their savings and draw down on those as and when they needed to. At the time of introduction there was considerable concern expressed by many parties, including the IAPF, regarding the merits of ARFs. Much of this related to the prospect of individuals, through a combination of poor investments and too many drawdowns, running out of funds.

Since the introduction of ARFs there have been many changes to the pensions landscape including consistent low levels of interest rates and higher assumptions of life expectancy which has led to higher annuity rates. Therefore while it would not have been unreasonable for someone at 65 expecting to live for 10 to 15 years to lock into an investment based on an assumption of 8% growth per annum, it does not seem so reasonable to force someone to lock into the same investment based on 4% growth per annum for 20 years or more.

Furthermore PRSAs have now been introduced and there has been a continuation of the growth of DC schemes which looks likely to be maintained.

Whilst there may be many issues with annuities, they have the advantage that they provide the certainty of a given level of income for life. There are some protections built into ARFs in that individuals wishing to avail of the option must prove they have a specified income of €12,700 per annum. If they do not they must transfer €63,500 to an Approved Minimum Retirement Fund (AMRF). This initial capital transferred to the AMRF can not be withdrawn until the individual is aged 75, at which stage it becomes an ARF.

Experience to date however has shown that, in reality, the high net worth individuals who have been able to transfer their accumulated retirement savings to ARFs have not been drawing down on them to the extent feared. As a means of addressing this issue, the Finance Act, 2006 included a deemed distribution tax whereby the Revenue Commissioners could tax ARFs where drawdowns are not being made.

***Exclusion of DC Members***

Members of DC schemes are excluded from the option of transferring to an ARF (except for any AVCs they might make). The IAPF strongly believes there is no logical basis for this exclusion. This exclusion means that there is not a level playing field among, otherwise, very similar forms of pension provision. What was already a complicated area, in terms of the format in which contributions can be paid and benefits taken, is now further complicated. PAYE DC members can only avail of the ARF option in respect of any AVCs that they pay. PAYE employees can however avail of the ARF option if they arrange their retirement provision through a PRSA. The availability of the ARF option should not determine which form of retirement provision an individual or employer wishes to utilise. That choice should be based on what best suits the workforce and on the charges that apply. Many DC schemes can operate on significantly lower charges than a standard PRSA and this should be the dominant factor in making those choices.

Because of the different subtleties that now exist there is a danger that arrangements can be manipulated to achieve the same result in any case. Examples include transferring DC benefits to PRSAs which can then avail of the ARF option or treating all employee contributions as AVCs to maximise the ability to avail of an ARF.

***Security of Benefit***

The original logic relating to the availability of the ARF option appears to have been based on the premise that those individuals who were proactive in providing for their retirement would have the ability to manage their funds in retirement. This seemed to indicate that those whose retirement provision was arranged through an employer did not have the same ability to manage their funds in retirement. There is no real basis for these assumptions and in any case there are more effective means of ensuring that the ARF option is only availed of by individuals who do have the ability to manage their funds in retirement. Furthermore the fact that PRSA holders can avail of the option means that individuals whose employers arrange retirement provision through a PRSA have the ARF option available to them.

There is no logic in this and it is unfair to exclude DC members purely because their retirement provision has been arranged in a certain way. It is clear though that the ARF option may not suit all individuals and that, for many individuals, the certainty and security offered by an annuity may be a better option for them. Determining whether or not this is the case should be a matter of individual choice after informed advice and consideration and not by means of arbitrary assumption. If individuals need to be protected from making poor choices this can be done by strengthening the regulation of the sale of ARFs.

In addition, the provisions in relation to the specified income and the amount that must be transferred to an AMRF could be strengthened as a means of providing further protection. Indeed the IAPF has frequently argued that the €63,500 limit beyond which pensions savings can be invested in ARFs as distinct from AMRFs is too low. This amount, which has never been increased since its introduction, appears to have been originally based on the notional capital value of the State Pension at that time. In today's terms that amount would be closer to €200,000.

Furthermore, members of DC schemes are increasingly involved in tracking and managing their retirement savings. As well as receiving annual benefit statements that allow them to track their savings, many DC members now have on-line access to their individual member accounts. This allows members to track their savings on a more frequent basis and even to change the funds in which they wish to invest or the level of contributions they can make. This level of member involvement will only increase following the introduction of further disclosure regulations including the requirement to furnish members with annual benefit projections. The accumulation of savings through individual accounts makes DC savings particularly suitable for transfer to an ARF as those individuals are already familiar with the concepts of managing their savings. For

that reason alone the ARF option should be available to all individuals who accrue retirement savings on a DC basis and not just to specified categories.

Indeed, this is also the reason that the IAPF believes that this option would not be appropriate for members of DB schemes (whether funded or unfunded), as there is no accumulation of savings on an individual basis. The focus of members of DB schemes is on the accumulation of a benefit and they track their pension accrual on that basis. Issues such as the cost of annuities make little real difference to those members as these will not directly impact the benefit they receive.

***Risk***

One of the general concerns in relation to DC provision is that the member carries all of the risk. The employer and employee commit to a given level of contributions and the amount of savings ultimately accumulated is dependent upon the investment return achieved. Generally, higher returns can be earned in investment classes that carry greater risk. As pensions are long-term investments individuals can often afford to hold a high proportion of investments carrying more risk in order to achieve a higher return over the long term. Many individuals move larger proportions of their savings to more stable and less volatile investment classes as they move closer to retirement. While this means that those individuals are more protected from potential losses caused by a downturn in, for example the equity markets, it also means they will not benefit from any gains in those markets. While, as has been evident in recent times, equity markets can suffer severe short-term volatility they do tend to perform on a more stable and consistent basis over the longer term.

However a DC member who is approaching retirement can suffer the short term volatility but does not have the opportunity to recover as the requirement to purchase an annuity at retirement age will lock in any losses occurred. The option to transfer to an ARF would allow the individual to continue to invest on a long term basis. Therefore allowing the option to transfer to an ARF removes one of the risks a DC member is subject to, which can only be in the interest of DC members and pension provision in general. As there are currently over 250,000 active members of DC schemes and almost all new schemes being established are on a DC basis, any measures that can reduce some of the risk carried by those individuals must be welcome.

It is illogical that DC members carry risk throughout their entire working lives, in the same way as those who are able to transfer to ARFs, but are then not allowed to continue to invest in retirement. This is the primary reason that this option is only suitable for individuals who accumulate retirement savings on a DC basis. Individuals who are members of DB schemes do not carry any investment risk and therefore it would not be logical or appropriate to suddenly allow them to do so in retirement.

***Higher Returns***

It is clear from the Life Strategies/Indecon analysis of the Irish annuity market that, at present, annuities are only being purchased by those individuals who are forced to purchase them i.e. DC members. Those that have a choice such as DB trustees or those who can avail of ARFs, choose not to purchase annuities, largely because of the fact that they are seen as offering poor value. The certainty offered by annuities comes at a heavy price for many reasons including the cost of capital to the insurer, the relatively low return on the assets with which the insurer has to match the liability, longevity assumptions and the expenses and profit margins of the insurer.

An individual does not have any cost of capital issue and, with the appropriate appetite for risk and the ability to carry risk, can invest in different asset classes than an insurer which is largely restricted to investing in bonds. These factors allow the individual the opportunity of achieving a higher return in retirement.

***Taxation***

There appears to be some concern that any moves to increase the availability of ARFs will result in a reduction in the amount taxation collected through the payment of pensions. The concerns appear to relate to the fear that individuals who avail of ARFs will not take draw down on the funds and therefore escape income tax. This would represent a considerable loss to the Exchequer as it would not collect the income tax it would have expected to collect and indeed the taxation it had deferred.

This concern tends to relate to the initial experience of ARFs where drawdowns appear to have been lower than would have been expected or where no drawdowns have been made on ARFs. However, in analysing the initial experience it must be remembered that the individuals who could initially avail of an ARF were the self-employed, proprietary directors and individuals with AVCs. Many of these individuals would have the ability to use an ARF as part of estate planning rather than pension provision. Many may also be in a position not to require any income initially, as being self-employed or proprietary directors they are more likely to continue to work than they would if they were subject to a compulsory retirement age. They are also likely to be in a position to avail of financial advice which would make them aware of the benefits of ARFs, particularly as part of estate planning. Indeed, it is somewhat ironic that the only individuals allowed to transfer to an ARF were those who were least likely to need to draw down on the funds. It also makes little sense in the context of the generosity of the tax reliefs that seek to encourage individuals to save for retirement that their hands are then tied in relation to how they can invest their funds at retirement.

In any event, there are other methods available to deal with these issues such as reviewing the taxation position of ARFs that are not drawn down upon and end up being passed on following the death of the ARF holder and, as has happened, applying a deemed distribution tax. The IAPF strongly believes that it is completely unreasonable to

allow the concerns about existing issues to prevent other individuals the same opportunities where there are no other logical reasons for doing so.

According to figures from the Irish Insurance Federation (IIF) contained in the Pensions Board's National Pensions Review a total of 7,815 ARFs were set up between 2000 and 2004 with IIF members and the total paid into those ARFs was €1,226,123,000 an average of €156,895 per ARF. This amount is likely to be larger than the average available to a DC member after that member has taken a tax free lump sum. For the reasons outlined earlier it is reasonable to assume that almost all annuities sold from 2000 to 2004 were in respect of members of DC schemes as the figures show a switch to ARFs from annuities from that date. A total of 6,307 annuities were sold in that period and the total premium was €574,591,000, an average of €91,104 per annuity.

Based on these figures it is unlikely that the average DC member would have the capacity to transfer to an ARF, particularly where they have no other available income and do not have the option or desire to continue working. However for those that do have the capacity the option should be available. Furthermore, for those people who do transfer to an ARF the primary reason should be that they wish to enhance their income in retirement. There may be other reasons, such as the desire to have flexibility around when they start to receive their retirement income, but the overall aim should be to enhance retirement income and thereby securing a better standard of living in retirement.

Where individuals are successful in achieving that aim the Exchequer will also gain as there will have been more income to be taxed than if the individual had purchased an annuity. Indeed, based on the historical return rates available, where equities always outperform bond and cash rates over any extended periods of time, there should always be greater revenue from ARFs than from annuity payments and therefore more tax.

***Flexibility***

Being able to avail of the ARF option also provides the individuals with much greater flexibility in retirement. They can choose to vary drawdowns in accordance with their own particular needs. This could aid those individuals who wish to continue working either on a full-time or part-time basis as they could choose to make no or smaller drawdowns while continuing to work. This is also consistent with stated Government policy to examine means of facilitating those who wish to have the choice to work longer. It is also consistent with the Government's plans to allow individuals to defer payment of their State Pension.

Furthermore the capital available to an individual in an ARF may be more suitable in dealing with any long term care requirements than the income from an annuity.

***Death***

When purchasing an annuity, the prospect of dying shortly after the annuity commences payment and effectively losing the savings accumulated to the insurer is one that

individuals find difficult to accept. While individuals can use some of the accumulated savings to purchase spouse's and dependant's pensions they do see this as a big issue. Again this stems from the fact that DC members are accumulating their pot of money and find it difficult to comprehend that they can just hand that over to an insurer and that it then dies with them, irrespective of when that death takes place. With an ARF any unused balance on death can be transferred to a spouse.

***Conclusion***

In conclusion, the IAPF believes that ARFs should be available to DC members for the following reasons:

- Extending the ARF option to DC members creates a level playing field and it is logical and reasonable to do so as they accumulate retirement saving in the same way as the categories of individuals who currently have access to ARFs. The current rules on eligibility for ARFs can dictate or influence the choices individuals and employers make regarding the type and format of retirement provision when there are much more important and fundamental factors that should be considered

- The risk taken by DC members and the nature of accumulation of DC funds are the reasons that this option should only apply to funds accumulated in that way and why the ARF option is not appropriate for DB members. DB members do not take investment risk and accumulate benefits rather than funds

- Any concerns relating to individuals not properly managing their ARF can be dealt with by regulation of the sales process and by increasing the income or funds individuals must have available before they can avail of the option

- Allowing the option to avail of an ARF removes the timing risks associated with compulsory annuitisation. It also ensures that individuals who have carried risk throughout their working lives are not prevented from continuing to invest in retirement

- Transferring to an ARF allows individuals the opportunity to achieve higher returns on their funds in retirement

- Where higher returns are achieved there should be an increase in the overall tax collected on retirement income. Any taxation issues that exist on ARFs should be dealt with by taxation measures and not by exclusion

- The ARF option facilitates those who wish to defer or phase their retirement from the workforce

- It removes the concern that DC members have of losing their accumulated savings to the annuity provider should they die shortly after commencement of the annuity