A New Approach to Auto-Enrolled Pensions

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Seven Key messages
… Out with the old

1. Scheme per Draft Heads of Bill an imitation of AE in other countries
    - Which have not been particularly successful
2. Modelled on private sector DC schemes which have done little for ordinary workers’ pension prospects
    - Overcomplicated, and don’t pay pensions to retired members
    - Member must leave at retirement and buy individual product from financial institution
3. Difficult and costly to design and implement
    - Impossible to meet target implementation date of 2024
    - Long-term cost much higher than proposed charge of 0.5% of funds under management

Seven Key messages
…. In with the new

4. One fund, long investment horizon. NOT agglomeration of individual accounts
    - All contributions invested to earn high, sustainable returns in the long-term
5. Members remain in scheme from date of joining until death
    - Member’s share of fund grows during working years, reduces in retirement as pension withdrawn and interest in fund transferred gradually to younger members. Baton is passed.
6. Very long investment horizon delivers more than 50% better value. Returns smoothed so pension accounts look like high-interest savings accounts
    - Better value can be used either to improve benefits or to reduce contributions
    - Contribution for “adequate” pension falls from 14% (6%, 6%, 2%) to 9.1% (3.9%, 3.9%, 1.3%)
7. Smoothed scheme can be implemented quickly and cheaply
    - Just one account, valued once a quarter, versus 40+ unit-linked funds, each valued daily.
    - Long-term cost of administering scheme less than 0.5% a year of member accounts
    - Will give Ireland the best AE system in the world: for workers, employers, society at large

Out with the old …
Scheme as per Bill is standard DC

- Investments based on individual profiles (not overall fund profile)
- Member decides risk level, e.g.
  - Low risk/ low return (certain) or high risk/ high return (hope)?
  - How do workers decide what risk level is right for them?
  - Will the government offer free advice? If not, who advises?
- … or opts for default fund (in UK, c99% choose default fund)
  - High-risk when young; low risk = low return when fund value highest
    - Investment return in one year at older age could exceed total return in first 10 years
- Complicated for members: NEST scheme (UK) has 46 default funds
  - Co-workers earn different returns, even if both choose default option

…. In with the new
Smoothed AE is different: one fund for all

- Positive scheme cash flows assured for decades to come
  - So can invest for the very long-term, earning higher average returns
- Everyone gets the same return, irrespective of age or account size
  - Young or old, active or retired, big or small account value
- No sale of assets when a member dies or makes pension withdrawal
  - Assets remain in the fund; are transferred to next generation

Out with the old ….
Market values sacrosanct

- Daily valuations required for 40 plus unit-linked funds
  - Implies around 10,000 valuations a year (c40 funds, each valued on c250 days)
- Money added to or taken from member accounts on each valuation date
- Market values can be subject to wild swings, e.g.

Jan 2020	Feb 2020	Mar 2020	Apr 2020	May 2020	Jun 2020
-3.3%;	-8.9%;	-15.1%;	+4.9%;	+3.4%;	+1.5%

  Values down 25% in three months.
  Movements of this scale unusual but by no means unprecedented

- Sharp falls in market values can cause workers to lose faith and stop contributing
  - Could be a contributory factor to observed high lapse rates in UK

… In with the new
Smoothed value, not market value rules ok

- Smoothing: key proposal in award-winning 2022 paper to UK actuaries
  - Brief for competition: " … ***to propose a system, or reform to the current system, which would deliver a low-cost affordable pension to the majority of the population*** …"
  - Key claim in paper: smoothed values and smoothed investment returns help ensure more than 50% better value to members.
- Transforms AE from "investment a/c" to "high interest savings a/c"
- E.g., market returns in first six months of 2020 (as above):

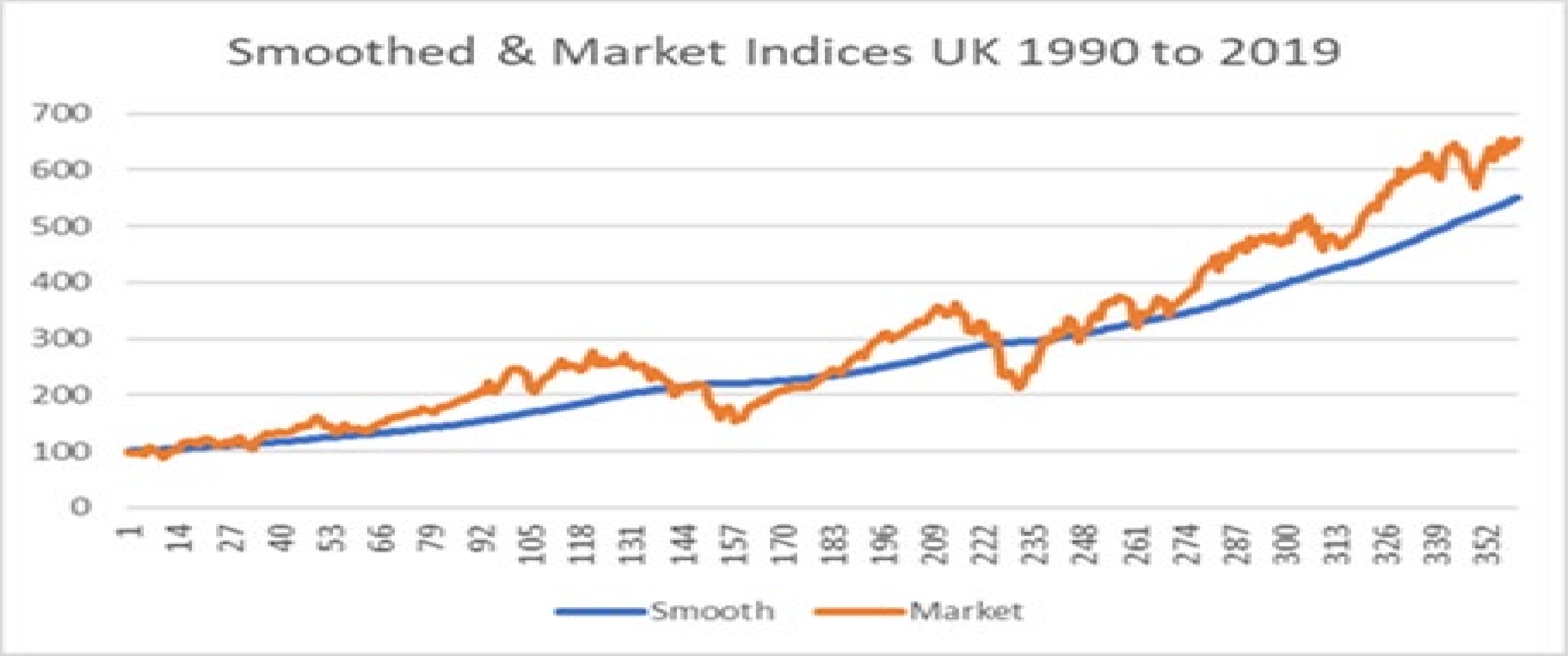
Jan 2020	Feb 2020	Mar 2020	Apr 2020	May 2020	Jun 2020
– 3.3%	-8.9%	-15.1%	+4.9%	+3.4%	+1.5%

- Smoothed returns for same six months (assuming 1 January 2020 scheme start date):

Jan 2020	Feb 2020	Mar 2020	Apr 2020	May 2020	Jun 2020
+0.29%	+0.23%	+0.13%	+0.25%	+0.31%	+0.33%

- In this example, smoothing reduces monthly fluctuations by 99%
  - Range lowest to highest falls from 20% (-15.1% to +4.9%) to 0.20% (0.13% to 0.33%)
  - Minimal risk of negative smoothed returns (none in UK or US for last 30 years at least)

Graph showing smoothed & market returns for a sample market, sample period
(Long-term comparisons much the same for other markets & other periods)



Out with the old ….
Members must leave the scheme at retirement

- Head 58 of draft Bill insists that members <u>must</u> leave at retirement; Head 59 says that drawdown MAY be added in future
  - Like designing a car without brakes, and saying that brakes may be added in future
- Will innovation by financial institutions save the day?

Example of innovation in financial services: Front Page Ad, Irish Times 1 January 2022

In reality, it’s financial Russian roulette:

- 5 in 6 chance of getting capital back in full
- 1 in 6 chance of losing more than half initial investment (average loss more than 60%)
- Zero chance of losing “just” 10%, 20% or even 40%. Must be over 50%

Out with the old ….
Members must leave scheme at retirement

- Head 58 insists that members must leave at retirement; Head 59 says that drawdown MAY be added in future
  - Like designing a car without brakes, possibility of adding brakes in future
- Can future innovation save the day?
  - Unlikely. Advice needed at & after retirement. Good advice expensive.
- Required contribution rate for "adequate" pension must make assumptions NOW on what happens IN FUTURE when members retire
  - 14% recommendation assumes just 0.5%pa net after retirement - forever
  - Assumes future inflation will be higher than investment returns –forever
  - Retirees could live 30 years or more - negative real returns for entire period?

…. In with the new
Members remain in smoothed scheme for life

- Seamless transition from pre- to post-retirement
  - Just change from adding to account to making regular withdrawals from it
- Continue to earn “interest” at average of deposit rate plus 4% a year
  - Average smoothed returns well above inflation, including in retirement
- Flexibility on when to retire and how much to withdraw each year
  - No need to link pension commencement date to state pension age
  - Can vary pension amount, e.g., less if working part-time; more if a dependent
- Neat proposal to eliminate risk of outliving one’s savings in retirement
  - Can opt for a lower “interest rate” from 75 and withdraw full account over next 15 years; guarantee that payments will continue for life after age 90

Out with the old …
Margins not sufficient to cover costs

- Proposed charge: 0.5% of member accounts (approx. = NEST charge)
- As at Mar 2022, NEST had a cumulative deficit of £800 million
  - Despite long history – NEST established following UK Pensions Act 2008
  - Trustees of NEST don't expect to clear deficit until 2038
- NEST economies of scale (11 million members versus 750k for Ireland)
  - Average contribution just £43 a month, average fund size £2,200
  - Implies poor persistency. High drop-off rates delay break-even date
- Required breakeven charge for Ireland will be close to 1% pa
  - Higher charge will have severe negative impact on member benefits

…. In with the new
0.5% more than sufficient for smoothed scheme

- Higher revenues, lower costs than under scheme as per Heads of Bill
- **Higher revenues** because members stay in scheme post-retirement
  - Margin in one year for retired member could exceed margins in first 10 years for young worker
- **Lower costs** because fewer moving parts
  - Four valuations a year (one fund, valued quarterly) versus circa 10,000 valuations a year for unit-linked funds (over 40 unit-linked funds valued daily)
  - Member accounts administered like high-interest savings accounts. Everyone, irrespective of age, account size, status gets the same rate
- **End result**: Speedy implementation, less operational risk, lower costs

Next steps?

- Smoothed scheme is novel. Government must appoint experts to complete an independent assessment
  - Experts must have expertise in macro and micro economics, investments, behavioural economics
- Experts' initial task will be to review CF's award-winning paper to UK Institute and Faculty of Actuaries (2022) and paper to Society of Actuaries in Ireland (2021)
  - https://actuaries.org.uk/media/q42dthzb/colm-fagan.pdf
  - https://web.actuaries.ie/events/2020/11/webinar-new-approach-auto-enrolment-higher-pensions-half-cost
- CF and Brian Woods will be happy to work pro bono with experts appointed and to share with them their analyses, models, spreadsheets
- State will save close to €200 million a year when scheme reaches a mature stage
  - Plus enormous (3x) benefits to workers, employers & society at large from having the world's best AE system, more than 50% better value, plus complete elimination of sharp fluctuations in account values
- **Efforts to implement scheme proposed in Draft Heads of Bill are doomed to fail: too difficult to introduce, too costly to administer. Choosing smoothed scheme will ensure earlier delivery**

Appendix

To be shown if asked on similarities to/differences from “with-profits”

Key Differences from With-Profits

- No actuarial or board discretion on calculation of quarterly “interest” rates
  - Rates determined by an objective formula, no discretionary element
- No actuarial or board discretion on asset mix: 100% in “equities” - always
- No guarantees
  - Minimal risk of negative return, e.g. positive quarterly returns in UK, US for last 30 years at least
  - Therefore, no risk of selling equities pro-cyclically into falling markets, as happened for WP
- No need to hold back returns to create an “estate”
  - Buffer account eventually (after c30 years), funded by margins in management fee from c year 20
- Regular contributions only, no lump sums
  - Lump sums, invested at top of market, caused big problems for with-profits companies when markets subsequently collapsed
- Everyone gets the same return: young/old; active/retired; big and small accounts
  - With-profits has wide and confusing variety of “reversionary” and “final/terminal” bonuses